Euro Area: Sovereign Debt Crisis Update

Schäuble puts a limit on ESM direct bank recapitalization

- **ESM direct bank recapitalization** – After the EcoFin meeting, German FinMin Schäuble said *"It's clear [the amount the ESM should use for direct recapitalization of banks] must be significantly below the €80bn paid-in capital, somewhere between nil and €80 bn."* Comment: if this limitation is valid, the ESM is probably unable to fulfill the aim of breaking the dangerous link between banks and sovereigns.
- **Draghi's remarks on OMT and on Spain –** Draghi tells the Spanish Parliament that OMT can only be used *"if there are major problems in the transmission of monetary policy and if there is strict and effective ESM conditionality"*, making clear that the purpose of the OMT is not to eliminate spreads between euro area sovereign bond yields. Discussing the Spanish situation, Draghi said Spain has made enormous progress in the past year, but he also underscored the need for additional fiscal tightening efforts.
- **Draghi says the term currency war is "way, way overdone"** for the current situation, although he confirmed the exchange rate is important for economic growth and price developments. He also criticized policymakers commenting on exchange rate policies.
- **Spanish officials optimistic on deficit and growth numbers.** Rajoy says *"2012 public deficit data will show unprecedented fiscal consolidation efforts"*. Budget Minister Montoro said he will negotiate with EU Commission/IMF the rhythm of public deficit cuts so as not to worsen the recession, which he expects to be less severe in 2013 than in 2012.
- **French 2013 budget deficit unlikely to hit 3%-of-GDP target,** says state auditor, unless *"new and significant measures"* are adopted, after a possible modest overshoot of the 4.5% 2012 deficit target. The audit court also deplored that 3/4 of the adjustment (worth almost 2pp of GDP in 2013) was dependent on revenue increases, which would dampen economic activity. .
- **Hollande admits 2013 GDP forecast could be lowered *"in the next few days",*** from the current projection of 0.8%, acknowledging *"numerous uncertainties"*. Comment: Release of the flash Q4 GDP estimate on Thursday may provide the timing for the revision of the 2013 growth baseline.
- **Cyprus – Eurogroup trying to lower the size of bailout,** says Eurogroup head Dijsselbloem. Russia may be involved in the final bailout, he said, but the large presence of foreign depositors in Cyprus also plays a role in finding a deal.
- **Slovenia – S&P cuts Slovene sovereign rating by one notch to A-,** four notches above the speculative grade BB+, on uncertain growth outlook and likely higher debt burden due to support of state-owned banks.
- **Slovakia –** We cut our 4Q12 GDP forecast to -0.3% QQ from zero previously.
- **Sweden –** Riksbank leaves rates unchanged at 1.0%.

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- **Schäuble wants to limit direct bank recapitalization.** After the EcoFin meeting yesterday German Finance Minister Wolfgang Schäuble was specific about the amount the ESM should use for direct recapitalization of banks. He said *"It's clear it must be significantly below the €80 bn paid in capita*l, somewhere between nil and €80 bn." Note that Eurogroup countries pay in €80 bn in order to get the overall lending capacity of the ESM to €500 bn, the rest (up to €700 bn) is callable capital. As other officials mentioned before, the ESM would have to back direct recapitalization of banks with more capital than lending to sovereigns. Comment: With only €80 bn to support banks the ESM probably is unable to fulfil the aim of the heads of state and government to decouple banks from the sovereign sector in the periphery member states.

- **Draghi on limits of the OMT.** According to the text published on the ECB's website, ECB President Mario Draghi said in his speech at the Spanish Parliament that *"The ECB can only consider OMTs if there are major problems in the transmission of monetary policy and if there is strict and effective conditionality attached to an appropriate European Stability Mechanism (ESM) programme".* Comment: Mr. Draghi again made very clear that the ECB will only activate the OMT when a country has fulfilled the necessary conditions, i.e. being under an ESM programme in the form of an ECCL and that the ECB with this measure is not targeting the elimination of spreads between periphery sovereign bonds and bund yields.

- **Draghi praises Spain but calls for medium-term fiscal plan** - ECB President Mario Draghi indicated in a press conference on Tuesday that his visit to Spain has been designed to recognise the efforts of Spaniards, as the country had made enormous progress since November 2011. He stressed that Spain was on the right track and was seeing several positive signs, noting that Spanish banks were now properly capitalised and in a position to extend credit to the economy. He underscored that while the labour market reform had increased flexibility, the government needed to comply with the EU fiscal framework and needed a medium-term fiscal plan. Comment: President Draghi is indicating very clearly that more efforts need to be made, and that the Governing Council will not support the relaxation of strict fiscal criteria which are seen as a necessary condition.

- **Draghi on exchange rate policy.** In respect of the currency, Mr. Draghi said later in a press conference *"I think the term currency wars is way, way overdone. We are not witnessing anything like that"*. While he repeated the importance of the exchange rate for economic growth and price developments in the euro area, he stressed again that the ECB has no exchange rate target. He also expressed his dislike of the discussion on more active currency policy initiated by French President Hollande, by saying that some of the comments on the exchange rate *"made by people not immediately related to monetary policy…are perhaps inappropriate or fruitless"*. Comment: Mr. Draghi made very clear that the ECB is against a more active exchange rate policy in the euro area as proposed by President Hollande.

- **Spanish officials sounding optimistic about fiscal consolidation and a return to growth** - Spanish Prime Minister Mariano Rajoy indicated during a press conference that the "*public deficit data for 2012 to be published in the coming weeks will show unprecedented fiscal consolidation efforts have been made*", adding that the cuts in times of recession had removed any doubts about the sustainability of Spanish public finances. Budget Minister Cristobal Montoro noted that his objective was to negotiate with the European Commission and the IMF the rhythm of public deficit cuts so as not to worsen the recession. Turning to

the outlook for economic activity, Mr. Rajoy argued that the contraction would be less severe in 2013 than in 2012, expecting to see economic recovery for end-2013, early 2014. Comment: while focusing on growth must be the government's priority, it is doubtful that the economic situation will turn around sufficiently rapidly, or that the international organisation will change their recommendations on the extent of budget deficit reduction for this scenario to materialise before 2014, in our view.

- **French 2013 budget deficit unlikely to hit 3%-of-GDP target, says state auditor** - Didier Migaud, head of the state auditor La Cour des Comptes, warned on Tuesday that meeting the 3% budget deficit target would require "*new and significant measures*" after a possible modest overshoot of the 4.5% 2012 budget deficit target. While noting the unprecedented fiscal consolidation effort of €38bn (close to 2ppt of GDP) planned for 2013, the audit court deplored that 3/4 of the adjustment would be dependent on revenue increases, given the risks that the greater tax pressure would dampen economic activity against a backdrop of widespread fiscal consolidation among member states. The report suggests that assumptions for corporate tax receipts and levies on housing market transactions are over-optimistic. Turning to the public debt trajectory, Mr. Migaud sees the overall figure rising to more than 90% of GDP in 2013 and continuing to increase in 2014 and 2015. The report also stresses that the government is underestimating the costs of unemployment benefits on public accounts. Mr. Migaud also called on the European Union to *"specify the relative importance it attaches to the criteria of the nominal and structural balances*". Comment: we have been arguing for some time that the budget deficit will be overshot, to the tune of at least 0.5ppt, given our GDP forecast of a small 0.2% contraction in economic activity in 2013. We expect the government to refocus the debate on delivering a reduction in the structural deficit of 1.6ppt.

- **French 2013 GDP forecast could be lowered, says President Hollande** - French President François Hollande reiterated on Tuesday that his government remained committed to meeting the 3% budget deficit target but opened the door *"in the next few days"* to a downward revision of the 2013 GDP forecast of 0.8%, acknowledging *"numerous uncertainties"*. Comment: the release of the flash Q4 GDP estimate on Thursday may offer the government a window of opportunity to adjust the 2013 baseline. The problem will be whether to announce additional expenditure cuts to meet the nominal budget deficit target or to switch its communication to the structural budget deficit reduction target. Another critical factor in the spring will be the presentation by the government of its strategy of 2014 expenditure savings in order to cement the credibility of the fiscal tightening exercise.

- **Cyprus – The Eurogroup is trying to lower the size of a possible bailout** from euro area member countries, Eurogroup head Dijsselbloem said yesterday. Dijsselbloem mentioned that Russia may be involved in the final bailout, given the loan it had already extended to Cyprus in 2011. Also, the Dutch FinMin hinted at the many account holders with foreign backgrounds in Cyprus, part of whom are *“undoubtedly Russian”*, and said this plays a role in a solution of the negotiations. On the other hand, the front-runner in next Sunday’s presidential elections in Cyprus said that he would not sign any bailout deal that forced private depositors to take losses. Comment: Dijsselbloem’s comments suggest that some involvement of foreign depositors as contributors to the Cyprus financial assistance is being considered. Foreign deposits account for around 45% of total bank deposits, and amounted to around €27bn in December 2012, according to data from the Central Bank of Cyprus.

- **Slovenia – S&P cuts Slovene sovereign rating by one notch to A-, four notches above speculative grade BB+**. *"The likelihood of an increased debt burden due to support of its state-owned banks and uncertain growth prospects"*, accompanied by *"the policy-implementation risks"* are behind S&P's cut (Reuters, 13 February 2013). After this step the Slovene sovereign rating is equal to Fitch (cut by one notch on 8 Aug 2012) and two notches above Moody's (cut by three notches on 2 August 2012). Comment: S&P's cut in the sovereign rating could put pressure on politicians to find a way out of the current political crisis after their meeting with President Borut Pahor on Thursday.

- **Slovakia – We cut our 4Q12 GDP forecast to -0.3% QQ from zero previously** (data released tomorrow). Our cut in forecast reflects disappointing data from 4Q12, particularly the fall in industrial production (to - 3% YY in 4Q12 from +16% a quarter ago) and the surge in the unemployment rate (to 14% in 4Q12 from 13.4% in 3Q12). The larger fall in retail sales of 2.3% YY in 4Q12 after -1.4% in 3Q12 suggests that domestic demand will continue to struggle and highlights the underperformance of private consumption, which on average fell by 0.3% YY in 1Q-3Q12 vs. +2.5% YY average GDP growth in the same period. If our quarterly GDP forecast materializes, it would mean that GDP would likely decelerate to 1.4% YY swda in 4Q12 from 2.5% in 3Q12 (to 1.4% YY nsa from 2.1% in 3Q12) and to 2.2% YY in 2012 from 3.2% in 2011. This also implies a milder rate of economic growth in 2013 of 0.7% YY that reflects previous downside risks that, if industrial production decelerates faster than our forecast envisages, GDP growth could decelerate to below 1% YY in 2013. We see upside risk to our forecast that net exports will offset the fall in domestic demand, because in previous quarters the trade surplus remained in place as imports fell more than exports. Nevertheless, this does not change the implications for public finances. The Minister of Finance has already reflected the prospect of weaker economic growth in its tax prospects, as seen in the additional gap of €361mn in 2013.

- **Sweden – Stable Rates at 1.0%,** rate path signals only marginally higher probability of a 2Q-3Q rate cut. The Riksbank kept the repo rate unchanged at 1.00%, and said that the *"repo rate is expected to remain around this low level for the coming year"*. Both Deputy Governor Karolina Ekholm and Lars E.O. Svensson entered a reservation against the repo rate decision – she advocated a 25bp cut to 0.75% and he advocated lowering the repo rate to 0.50%. Deputy Governor Lars E.O. Svensson and Karolina Ekholm also entered reservations against the Monetary Policy Report and the repo-rate path in the Monetary Policy Report. Comment: Given the weak domestic economy and very low core inflation, our base case was for the Riksbank to cut by 25bp. We had warned, though, that today's rate decision was a very close call, acknowledging that the Bank equally well might prefer to postpone the rate cut to April, pending further clarification regarding the strength of the recovery in sentiment indicators and risk appetite. We expect the policy rate to trough at 0.75% in 2Q, and thereafter to be left unchanged for the remainder of 2013 and all of 2014. If, as we expect, stronger global growth gives Sweden a lift further ahead, the Riksbank will probably gradually raise the repo rate from 2015 and onwards.

Appendix A-1

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