

Economics

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Euro Area: Sovereign Debt Crisis Update

- **The rating agency Moody's has downgraded the Irish sovereign rating by two notches to Baa3, just one step before the non-investment grade category. The outlook is maintained negative.** The downgrade now leaves Moody's rating on Ireland the lowest among the major three rating agencies. The rationale for the rating cut has been the further weakening of government financial strength due to (1) the crystallisation of additional bank liabilities after the results of the bank stress tests; (2) the weak economic outlook driven by the fiscal tightening measures, which may actually need to be increased in order to reach the fiscal targets (3) tightening monetary policy. Moreover, the details of the future European Stabilisation Mechanism (ESM), which will increase the likelihood of bondholders' bail-ins from 2013, make the Irish credit risk higher, according to Moody's. Comment: together with Portugal, Ireland is now on the verge of losing its investment grade rating, as just one step away from double-B area.
- The governor of the Irish central bank said in a newspaper interview this morning that a longer-term funding facility by the ECB would alleviate the liquidity concerns of the Irish banks. He said, however, that it is understandable the ECB is reluctant to change its standard lending facilities – hence the lack of a final decision in the ECB's strategy to deal with the euro periphery addicted banks.
- **The results of the first negotiations between the new Irish government and the IMF/EU on the update of the economic adjustment programmes will be presented today.** According to press reports, they will mostly focus on labour market reforms which should help reduce private wages. The new government has been adamant about scrapping the previous government's 1 EUR cut in the minimum wage, but claims that other fairer measures could be taken to achieve the same reduction in labour costs. The fiscal targets are likely to be left unchanged relative to those agreed by the previous government in December 2010.
- **The Bank of Spain said yesterday** that, out of the 13 saving banks which submitted their restructuring plans and strategies to strengthen their capital positions at the beginning of March, **up to nine savings banks may need to tap the state-backed bank recapitalisation fund (FROB)** in order to reach the new requirements on capital ratios.
- **The Spanish banking system's liquidity uptake at the ECB stood at EUR 42.3bn in March, down from 50.5bn in Feb.** This is the lowest level of reliance on the ECB liquidity since January 2008, down from a peak of EUR 140bn in July 2010.

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In Greece the results of the new IMF/EU/ECB round of negotiations (leading to the fourth review) within the economic adjustment programme will be presented today. 2010 deficit and debt figures will most likely be revised upwards (deficit likely to be around 10.5% of GDP, instead of the original target of 8% set in the May 2010 programme). Future deficit targets for this year and the next (at 7.6% and 6.5%, respectively) should be left unaffected. Additional medium-term fiscal tightening measures will likely be announced to make up for past slippages, probably worth 10% of GDP, together with confirmation of plans to divest state assets for EUR 50bn (22% of GDP). However, it is unlikely that details of the privatisation plans will be given today. The new measure will have to be approved by Parliament by mid-May. Political risks are rising again in Greece, as a number of members of the governing socialist party have been expressing discontent on the government fiscal strategy.

Appendix A-1

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