

Eurozone Focus

Makeup Or Breakup

- *It is definitely a clear understatement to say that Europe is in a precarious situation and without a timely and efficient solution, faces the risk of falling into the abyss. The crisis had engulfed Greece, Ireland, and Portugal and now threatens to take down both Italy and Spain.*
- *Markets have also focused on the core of the Eurozone, with economic growth stalling in Germany and France, and questions being raised about the financial health of the large French banks and of France's own triple-A credit rating.*
- *There are several options available to policymakers at this juncture and we evaluate the effectiveness and ease of implementation.*
- *The weeks and months ahead will bring greater uncertainty and volatility as there will be some very important decisions, and these developments will potentially impact global market sentiment.*

Despite the incredible efforts fronted by the EU/IMF/ECB Troika of lenders, Europe has not been able to solve their problems. Problems so huge, that massive intervention and aid programs so far, have been nothing more than a band aid. In fact, with every passing day, the idea of a break-up of Europe seems less and less remote.

At the same time, there are growing conflicts between the Troika on how to respond to the crisis. Currently, the biggest form of risk comes in the form of politics. Leaders from the core countries are facing immense pressure from domestic voters, who are disgruntled at the bailout of the weaker peripheral countries.

What Has Changed: A Look At Some Of The Recent Developments

Whilst the Germany's Constitutional Court had cheered financial markets earlier last month (September 7) by ruling that the country's participation in the rescue of heavily indebted European nations can go ahead; it offered no long-term solutions and did essentially nothing to resolve the nation's crisis, with the bailout just allowing indebted nations to borrow more. Clearly, the month that passed have seen risks intensified and also saw plenty of noises raising fears of a Greek default.

In our last quarterly report, the background to discussions in the Eurozone then, had been associated with two issues. First, being the fifth disbursement of EU/IMF financial aid for Greece; and second, on how Greece can meet the expected shortfall in refinancing from early 2012.

Focus Now Turns To The Sixth Disbursement of EUR8 bln

On the former issue, we highlighted before that for Greece, it remains largely a three-month rolling crisis. Indeed, talks between Greece and international inspectors on whether it has met conditions for the new aid tranche (the sixth disbursement as part of the first Greek bailout package)

have been put on hold, after disagreements over why and by how much its deficit cuts program has fallen behind schedule.

In one of the latest developments, the Greek government has approved on October 2, EUR6.6 bln of austerity measures, including large layoff of state workers (likely to trigger street protests), and these steps are expected to cut deficit from 8.5% to 6.8% of GDP (EUR14.7 bln) this year. Yet, the new austerity still falls short of the 6.5% target set by the Troika. In addition, the MoF said the budget deficit is now seen at 8.5% of GDP this year (compared to a bailout target of 7.8% of GDP) and 6.8% of GDP next year (compared to a bailout target of 6.5% of GDP).

Greece and EU-IMF Drawdown Schedules				
		IMF	EU	Total (EUR bln)
1st	2Q10	5.5	14.5	20.0
2nd	3Q10	2.5	6.5	9.0
3rd	4Q10	2.5	0.0	9.0
4th	1Q11	4.1	17.5	15.0
5th	2Q11	3.3	8.7	12.0
6th	3Q11	2.2	5.8	8.0
7th	4Q11	1.4	3.6	5.0
8th	1Q12	2.7	7.3	10.0
9th	2Q12	1.6	4.4	6.0
10th	3Q12	1.6	4.4	6.0
11th	4Q12	0.5	1.5	2.0
12th	1Q13	1.6	4.4	6.0
13th	2Q13	0.5	1.5	2.0
				110

Source: IMF; Bloomberg; UOB Economic-Treasury Research

Whilst the recent measures should enable Greece to get its next tranche of aid from the EU/IMF and stave off a

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near-term default; the pause in discussions is a clear sign of tension between the nation and the Troika, and this will be an ongoing source of uncertainty. Before long, the December negotiations for the seventh disbursement will come around, and is likely again to stir market uncertainty.

What About The 2nd Greek Bailout Package?

As it is, even the new package agreed for Greece at the EU's summit on July 21 is running into its own problems. The package was meant to address the second issue aforementioned above, and had consist of two parts: First, EUR109 bln of government funding and private contributions (banks to contribute EUR50 bln through bond exchanges and buybacks); and second, a revamp of the European Financial Stability Facility (EFSF).

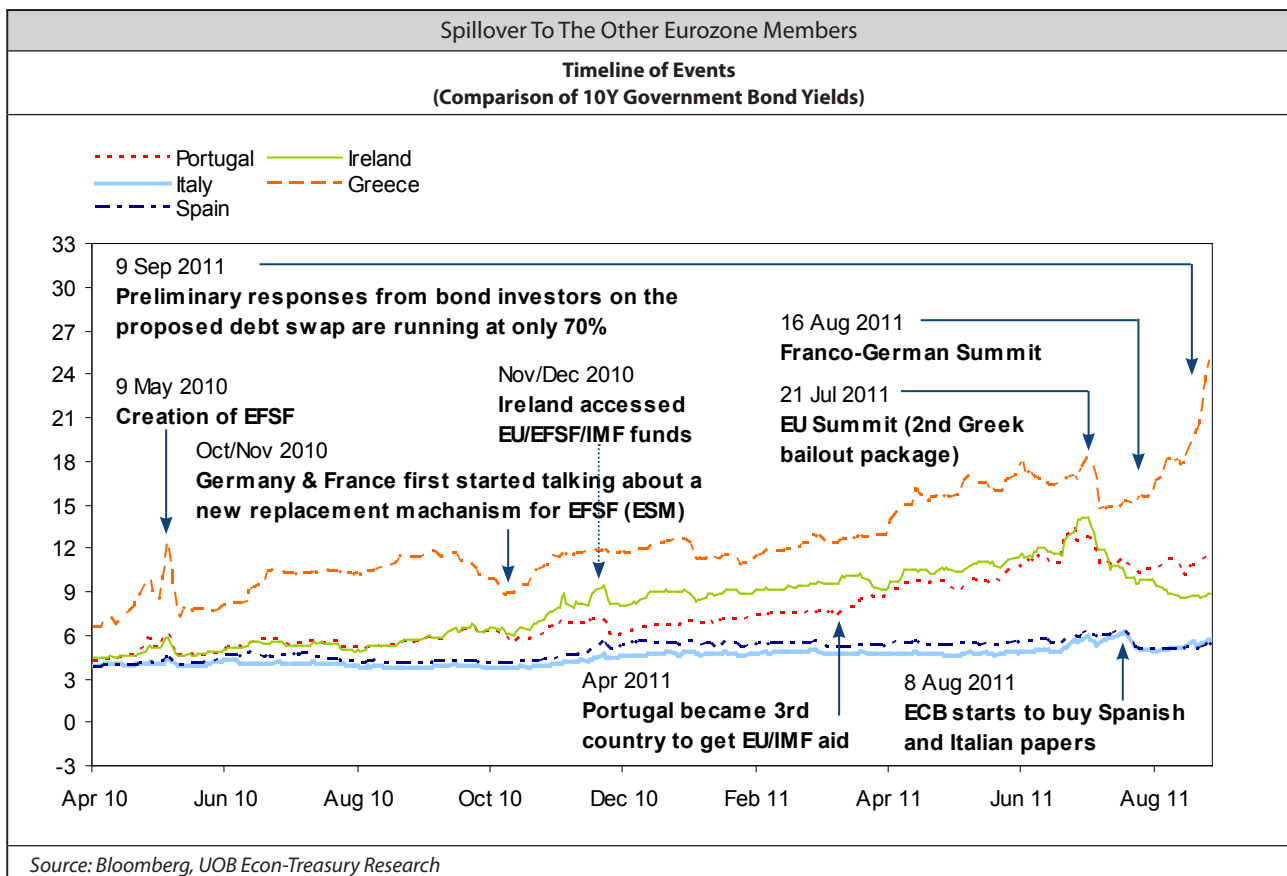
That said, the EU plan will require individual's country's parliamentary approval. As of writing, 12 states, including Germany, have backed the expanded power (final ratification hopefully by mid-October). Among the rest, only Slovakia's endorsement appears politically difficult. Even then, the current EFSF effective lending capacity is already stretched, and would not be sufficiently credible to cover any financing shortfall for Spain and Italy. More importantly, private sector participation in the Greek debt restructuring is on a "voluntary basis".

Sparking the recent market jitters were media reports suggesting that the preliminary responses from bond investors on the proposed debt swap are running at only 70% by the September 9 deadline, well short of the minimum take-up of 90%. While the plan is to swap some EUR135 bln in Greek government bonds maturing between now and 2020 into new 15- and 30- year debt for a 21% haircut, Greek officials have threatened to cancel the debt swap if participation is less than 90%. According to a Greek newspaper report on September 15, the private-sector participation rate has gone up to 82% since and will likely reach the 90% target once pension funds and mutual funds are included. Nonetheless, the participation deadline has now been extended to mid-October.

Spillover To The Other Eurozone Members

It is definitely a clear understatement to say that Europe is in a precarious situation and without a timely and efficient solution, faces the risk of falling into the abyss. The Eurozone crisis had engulfed Greece, Ireland, and Portugal and now threatens to take down both Italy and Spain.

Markets have also focused on the core of the Eurozone, with economic growth stalling in Germany and France in the second quarter, and questions being raised about the financial health of the large French banks and of France's



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own triple-A credit rating. To make matters worse, two of France's top banks, Societe Generale and Credit Agricole, were downgraded by Moody's on September 14, with the rating agency saying its concerns about their funding and liquidity profiles had increased in the light of worsening refinancing conditions.

There are several options available to policymakers at this juncture and we evaluate the effectiveness and ease of implementation.

EFSF: The Mechanism And The Challenges

In its original form, the EFSF included total guarantees worth EUR440 bln; but in order to keep its triple-A status, the fund could lend at most EUR255 bln (the amount of guarantees provided by triple-A sovereigns). In its new form, its total guarantees were extended to EUR780 bln; with the triple-A rated countries contributing around EUR451 bln.

Limitations of the EFSF

The biggest challenge facing the EFSF is the structure itself. The whole idea of getting distressed members to pose guarantees for other peripheral sovereigns is just flawed.

Moreover, the whole mechanism is supported in large by Germany (27%) and France (20%). Should Spain and Italy be removed from the equation, the contribution key of these 2 bastions of Eurozone is estimated to be more than 70%. In the worst case scenario of France losing its AAA status, it will no longer be able to provide guarantee commitments (so that EFSF gets to retain its AAA status). This would truly be disastrous and untenable because Germany would be the "last sovereign standing" and would have to provide for close to 80% of the total guarantees. Judging from the political pressure faced by Merkel back home, it would truly be far-fetched to expect Germany to be willing to carry this burden.

Another challenge is that of size. Despite boasting a total fund size of EUR770 bln, the effective lending capacity is effectively only EUR440 bln. Whilst this is believed to be sufficient to bail out Greece, Ireland and Portugal; it will not be able to absorb both Spain and Italy if they go under as well. With the taxpayers of the core sovereigns explicitly expressing their discontentment at the bailouts, it will increasingly be more difficult for political leaders to increase the size of the EFSF without facing substantial backlash.

EFSF Guarantee Structure (pro-rated guarantees) €bn, unless otherwise stated				
Country	Credit Rating (S&P/Moodys/Fitch)	Original EFSF Maximum Guarantee Commitments	Amended EFSF Maximum Guarantee Commitments	Adjusted EFSF Contribution Key (%)
Austria	(AAA/Aaa/AAA)	12.2	21.6	3.0
Belgium	(AA+/Aa1/AA+)	15.3	27.0	3.7
Cyprus	(A-/Baa1/A-)	0.9	1.5	0.2
Estonia	(A/A1/A)	0.0	2.0	0.3
Finland	(AAA/Aaa/AAA)	7.9	14.0	1.9
France	(AAA/Aaa/AAA)	89.7	158.5	21.8
Germany	(AAA/Aaa/AAA)	119.4	211.0	29.1
Greece	(CC/Caa1/CCC)	12.4	21.9	0.0
Ireland	(BBB+/Ba1/BBB+)	7.0	12.4	0.0
Italy	(A+/Aa2 /AA-)	78.8	139.3	19.2
Luxembourg	(AAA/Aaa/AAA)	1.1	1.9	0.3
Malta	(A/A1/A+)	0.4	0.7	0.1
Netherland	(AAA/Aaa /AAA)	25.1	44.4	6.1
Portugal	(BBB-/Ba2/BBB-)	11.0	19.5	0.0
Slovakia	(A+/A1/A+)	4.4	7.7	1.1
Slovenia	(AA/Aa2/AA)	2.1	3.7	0.5
Spain	(AA/Aa2/AA+)	52.4	92.5	12.8
Total	-	440.0	779.8	100.0
Of which AAA	-	255.4	451.5	62.2

Source: EFSF; UOB Economic-Treasury Research

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Remaining EFSF Guarantees (Amended Structure) €bn, unless otherwise stated							
Member state		ECB Capital Subscription	Contribution Key	Max Guarantee Commitments	Max Remaining GuaranteeA	Adjusted Cont KeyB	Adjusted Cont KeyC
Belgium		2.43	3.47%	27,032	25,393	3.72%	5.47%
Germany	AAA	18.94	27.05%	211,046	198,250	29.07%	42.71%
Ireland		1.11	1.59%	12,378			
Spain		8.30	11.87%	92,544	86,933	12.75%	
France	AAA	14.22	20.32%	158,488	148,878	21.83%	32.07%
Italy		12.50	17.86%	139,268	130,824	19.18%	
Cyprus		0.14	0.20%	1,526	1,433	0.21%	0.31%
Luxembourg	AAA	0.17	0.25%	1,947	1,829	0.27%	0.39%
Malta		0.06	0.09%	704	662	0.10%	0.14%
Netherlands	AAA	3.99	5.70%	44,446	41,751	6.12%	8.99%
Austria	AAA	1.94	2.78%	21,639	20,327	2.98%	4.38%
Portugal		1.75	2.50%	19,507			
Slovenia		0.33	0.47%	3,664	3,442	0.50%	0.74%
Slovakia		0.69	0.99%	7,728	7,259	1.06%	1.56%
Finland	AAA	1.25	1.79%	13,974	13,127	1.92%	2.83%
Greece		1.96	2.81%	21,898			
Estonia		0.18	0.26%	1,995	1,950	0.27%	0.40%
Total		69.97	100%	779,783	682,057	100%	100%
of which AAA				451,540	424,163	62.2%	91.4%
Excluding France				293,052	275,284	40.4%	59.3%
A. Maximum remaining guarantees by country taking account of all issuance to date and planned for 2011							
B. Contribution key adjusted for Greece, Ireland and Portugal stepping out as guarantors							
C. Contribution key adjusted if Italy and Spain additionally step out							
Source: EFSF; UOB Economic-Treasury Research							

What Else Can Be Done?

There have been talks of late about potentially leveraging up the EFSF. What was supposedly a bazooka response when first introduced in 2010 had to be amended for "upsized" on July 21 to EUR440 bln (as of writing, we still have not achieved a 100% ratification of the amendment by all 17 national parliaments). Market has indeed moved ahead once again and is now suggesting the drastic idea of leveraging up the assets of EFSF. Given the total EUR440 bln size of the EFSF, it has been suggested that the first 20% of losses be absorbed by the EFSF (much like the equity tranche of a CDO), this would translate into a fund size of EUR2.2 bln. If we adjust the above numbers for aid that had already been meted, the effective guarantee of the levered EFSF will be closer to EUR1.5 trillion. This levered size should be more than adequate in bailing out Italy and Spain should the assistance be required.

Given the political pressure posed by electorates of dissatisfied core countries, it is really difficult to fathom

that the idea of turning EFSF into a CDO (which was the catalyst for the 2008 crisis) will be allowed to take place. However, should things deteriorate and get out of control, the political leaders might have no choice but to turn to this solution to inject the much needed confidence to keep the Euro project alive.

There have also been discussions about turning the EFSF into a bank. The idea, mooted by Daniel Gros & Thomas Mayer, was to transform the EFSF into a bank that can obtain re-financing with the ECB. Granted, if this idea was to take place, the "new" EFSF would have tremendous resources at disposal. This would then inject the much needed stability and confidence back into capital market which is otherwise sorely lacking now. However, in practice, this idea is fraught with both political and legality constraints. Article 123 of the Treaty of Europe contains a monetary financing prohibition and it will probably be illegal to fund sovereigns via the ECB balance sheet. This is akin to debt monetization and is something that ECB will be keen to

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avoid at all cost should it want to retain its credibility.

ECB Steps In - Bond Buying: But For How Much And For How Long?

ECB bond buying has stopped the collapse of the bond market (especially for Italy and Spain) and has indeed bought a significant amount of time. However, this has brought about questions on potential limits to ECB bond buying and successful sterilization in these purchases.

The ECB buys bonds through the Securities Market Programme (SMP), in the EGB market. The SMP was launched in May last year when the Greek crisis began. Currently, it sterilizes its bond purchases by conducting weekly liquidity-absorbing operations (announced each Monday, allotted each Tuesday), equal to the cumulative size of settled SMP transactions at the end of the preceding week, rounded to the nearest half billion.

It appears from the past month of purchases that SMP program is designed to keep the borrowing costs of Italy and Spain below 7% (believed to be the level where funding from capital market becomes unsustainable from a debt-growth perspective). The ECB is also cautious not to push the yields too low (i.e. below 5% for fear of attracting sellers that will defeat the purpose of their operations). Thus, we can expect the ECB to be active via the SMP between the range of 5-7%.

Since the programme is entirely at the discretion of the ECB; theoretically, the ECB has no size limit. However, the ECB has expressed deep concerns about its usage and the blurring of monetary and fiscal policies, compromising its independence and credibility. There have been suggestions of transforming the EFSF into a bank, which would then take-over the bond-buying process. Still, that will not prove to be an easy task, given that the EFSF will be more financially and politically constrained than the ECB itself.

In fact, Executive Board Member Juergen Stark became the latest council member to resign from the ECB, reportedly due to disagreement with the ECB's bond-buying programme. He is the second German to resign his ECB post this year, after Bundesbank President Axel Webber's departure, which is believed to be partly the same reason. Furthermore, there were three other dissensions from the ECB's emergency decision back on August 8 to start purchasing Italian and Spanish bonds.

As such, not only have the rift widened within the governing board on the issue of bond purchases, market participants have also begun to wonder about the eventual long-term credit risks accumulating on the Eurosystem balance sheet.

Hence, in our view, this is not a long-term solution for the Eurozone.

Eurobonds: What Could Be On The Table, And Why This Is Not An Easy Option

If the EFSF is deemed to be an interim solution for Eurozone, the issuance of Eurobonds is probably a longer term solution that is more than just a band-aid. In theory, the pooling of the liabilities of the 17 Eurozone countries to issue debt at a single interest rate can bring down the borrowing costs for the peripheral countries, aiding them in the restructuring of their fiscal deficit situation. This can target more directly the solvency issue by lowering the borrowing costs instead of throwing these peripheral countries into a vicious cycle of higher borrowing costs, lower growth trajectory and greater fiscal deficit. In contrast, the EFSF has been taking a "kick the can down the road" approach and has in all honesty been more of a liquidity measure more than anything else.

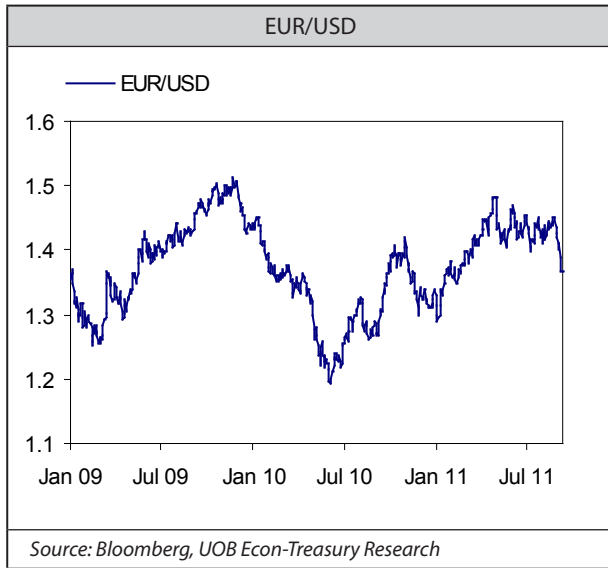
This begs the question as to why the idea of Eurobonds was not mooted earlier. This is simply because of the practical difficulties on the ground. Theoretically, it would be a wonderful panacea; but how do you convince countries like Germany who has kept their fiscal house in order to enjoy lower borrowing costs to "subsidise" their profligate Southern neighbours who has shown scant regard in keeping their fiscal deficits in check?

This is proving to be the greatest stumbling block so far as German officials have explicitly refuted the idea of issuing Eurobonds unless the countries in trouble get their act together, instill austerity measures and carry these reforms as promised. This is evolving into a classic chicken and egg situation and perhaps, if forced onto the edge of the cliff and faced with the prospect of a Euro breakup, only will Germany then possibly cave into the unreasonable demands. Otherwise, the idea of Eurobonds materializing anytime soon still looks quite remote.

A variation of the Eurobond that has been proposed in the market is the Red and Blue bonds (proposed by Bruegel, a Brussels-based think-tank). This suggests that the debt of the Eurozone sovereigns be divided into 2 sections. In this framework, the "Blue" bonds will be the senior tranche and can be issued up to 60% of GDP attached with joint and several guarantees. The "Red" bonds, on the other hand, will be the junior tranche and for any debt issued above 60% of GDP. It will also be treated as the debt issuance of the sovereign itself.

This is simply a variation of the EFSF and will not really change the 2 tier borrowing conditions that we are

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witnessing now. The junior tranche of Red bonds will inevitably be continued to be sold massively by markets, as it is likely that the countries issuing them will probably be those that are in trouble.

Nevertheless, European Commission President Jose Barroso said (September 14) he was close to proposing options on joint Euro area bond sales, putting officials in Brussels on a collision course with Germany over steps to contain the sovereign debt crisis. For the idea of Eurobonds to truly take place, it will require the political unity of all 17 Eurozone countries. Currently, we do not even see a general consensus among government officials in various countries.

On the Euro: Sovereign Debt Issues To Weigh

Despite recent steps taken to address the sovereign debt crisis, a lot more clarity is needed and the persisting uncertainty remains a headwind for the Euro region. As it stands, EUR/USD has already fallen considerably from August's high of 1.4549 to where it is trading currently.

Given that there are several developments that will potentially impact the Euro currency, there is still some room to decline should these pressures intensify. As it stands, European bank stocks have been hit hard, dragging broader equity markets lower. And the negative developments out of Europe could well carry on beyond the effects of the problems of weak growth in the US. As such, amid further volatility in the EUR/USD, we are looking for a depreciating trend in the EUR/USD going forward.

On Monetary Policy: ECB Switches To A More Dovish Bias

The September ECB meeting has culminated in the decision to hold the benchmark interest rate unchanged at 1.50%, as expected. There was a distinctly dovish change in the rhetoric out of the ECB, though.

The ECB's new staff forecasts for GDP growth have been revised down slightly — to a central rate of 1.6% for this year (versus 1.9% in June) and 1.3% for 2012 (from 1.7% in June). The risks to growth have intensified and moved to the downside from being balanced. Meanwhile, HICP inflation forecasts were also revised lower to 2.5-2.7% in 2011 and 1.2-2.2% in 2012. Critically, while inflation is seen to stay above 2% in the coming months, inflation risks are "balanced", no longer on the upside.

Clearly, the ECB has effectively withdrawn its inclination to raise rates, with Trichet maintaining that the ECB would continue to monitor very closely all developments. It does seem that the reversal of prior rate hikes has become more likely although the central bank is unlikely to do so quickly. December will be a crucial month since it will coincide with the next staff forecasts. But for now, we think that the refi rate is likely to stay at 1.5%.

A Tough Calendar Ahead - Key Events To Watch

If you thought August and September was a month of great volatility, be prepared for even greater uncertainty and volatility in the weeks and months ahead, as they will bring some very important decisions, and these developments will potentially impact global market sentiment.

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Date	Event
3 October	Eurogroup meeting in Luxembourg.
4 October	Ecofin meeting, whereby discussion will focus on steps to shield banks from further fallout from the Greek crisis.
6 October	The ECB governing council will meet. This is the last meeting with President Jean-Claude Trichet as he will be leaving the ECB by end-October.
7 October	The Netherlands' will vote on the EFSF reform.
8-9 October	Malta is expected to vote on the EFSF reform.
13 October	Originally planned for October 3, this is now the new target date for the Troika to approve the release of the next tranche of EUR8 bln to Greece.
14-15 October	G20 finance ministers will be meeting in Paris, France.
17 October	Slovakia is expected to vote on the EFSF reform.
17-18 October	EU Council Summit will be held in Luxembourg.
Mid-October	The participation deadline for the Greek debt swap plan has now been extended to mid-October.
3 November	ECB meets for the first time with Mario Draghi as the new President.
3-4 November	G20 annual summit will be held in Cannes, France.
7-8 November	Eurogroup / Ecofin meeting.
18 November	EU budget ministers will hold a meeting.
Late-November	IMF will start its sixth review for Greece.
29-30 November	Eurogroup / Ecofin meeting will be held in Brussels.

Source: Reuters, UOB Economic-Treasury Research