The Eurozone Crisis

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What’s wrong with the Eurozone?

- Rootcauses of the Eurozone Sovereign Debt Crisis
  - One monetary policy (ECB), but 17 fiscal policies that allow countries to tax, spend and borrow independently (a currency union is not a political union)
  - The “Stability and Growth Pact” has proved ineffective
  - Too much debt, too much of which is held by Banks
  - ECB allowed banks to hold European sovereign debt as if it has zero risk
  - Fiscal austerity measures will lead to vicious economic cycle (smaller economic growth > lower tax revenues > higher deficits > more budget cuts)
  - The end result is that five Eurozone countries have accumulated debt that the bond markets think excessive
- Why is it taking so long to resolve the crisis?
  - A ‘car accident in slow motion’ – difficult political decisions (requiring consensus) take time to get voters to agree to support the common cause of Eurozone
  - Denial of Reality - Greater efforts needed to arrest contagion

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Euro-area periphery – Markets question the ability to deleverage

The public debt trajectory is compounded by low GDP growth in most southern European countries

European Commission forecasts

Country	GDP growth		General government deficit (% of GDP)		Government debt (% of GDP)		Curr. account (% of GDP)
	2011F	2012F	2011F	2012F	2011F	2012F	2011F
Belgium	2.4	2.2	-3.7	-4.2	97.0	97.5	2.0
France	1.8	2.0	-5.8	-5.3	84.7	86.8	-3.9
Greece	-3.5	1.1	-9.5	-9.3	157.7	166.1	-8.3
Ireland	0.6	1.9	-10.5	-8.8	112.0	117.9	1.2
Italy	0.7	1.3	-4.0	-3.2	120.3	119.8	-3.5
Portugal	-2.2	-1.8	-5.9	-4.5	101.7	107.4	-7.5
Spain	0.8	1.5	-6.3	-5.3	68.1	71.0	-4.1
Euro area	**1.6**	**1.8**	**-4.3**	**-3.5**	**87.7**	**88.5**	**-0.2**
UK	1.7	2.1	-8.6	-7.0	84.2	87.9	-1.2
USA	**2.6**	**2.7**	**-10.0**	**-8.6**	**99.5***	**102.9***	**-4.0**

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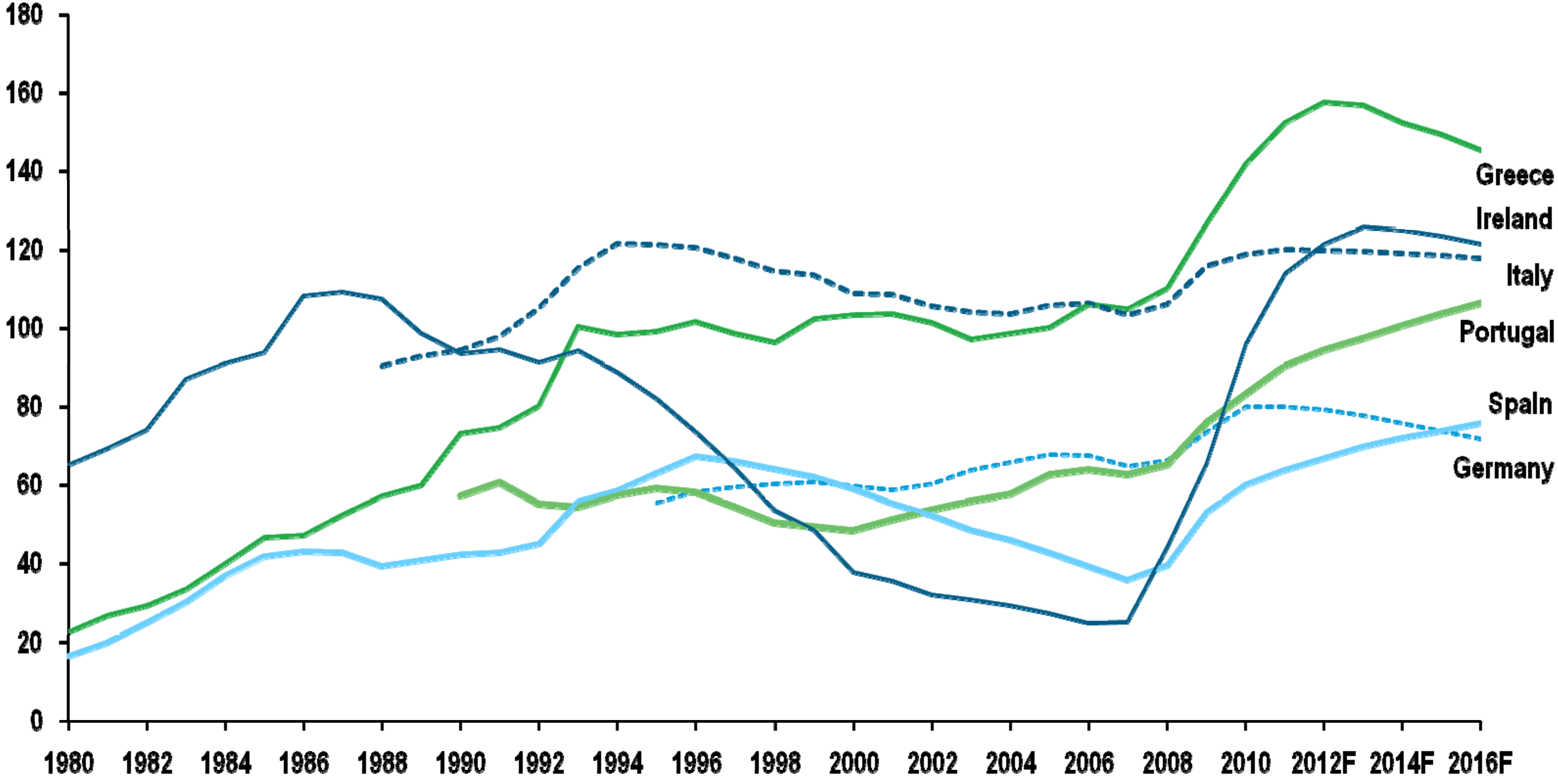
Sources: EC forecasts (September 2011 / May 2011) , except * : IMF WEO (April 2011)

Market reconsidering sovereign risk

Portuguese and Spanish debt not stabilised yet; slow deleveraging in Greece, Ireland and Italy

Debt-to-GDP ratios (%)

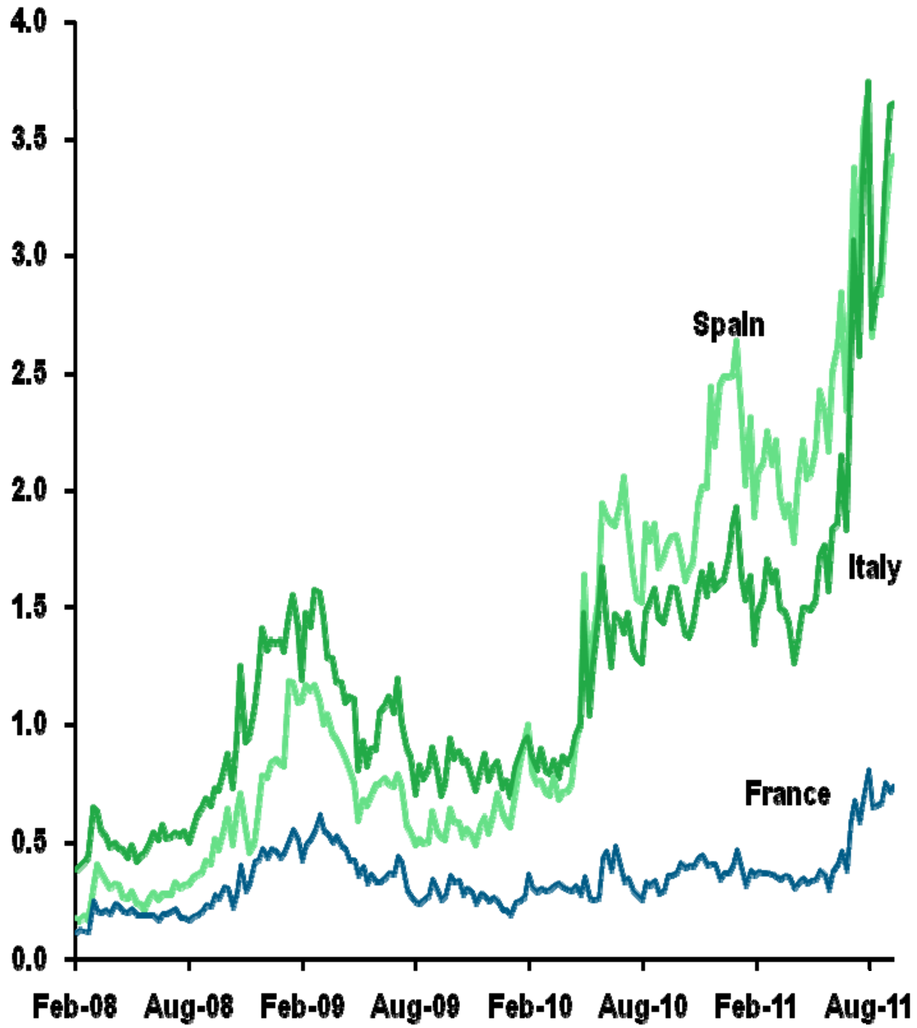


Source: IMF WEO (2011)

Escalating concerns over euro-area periphery

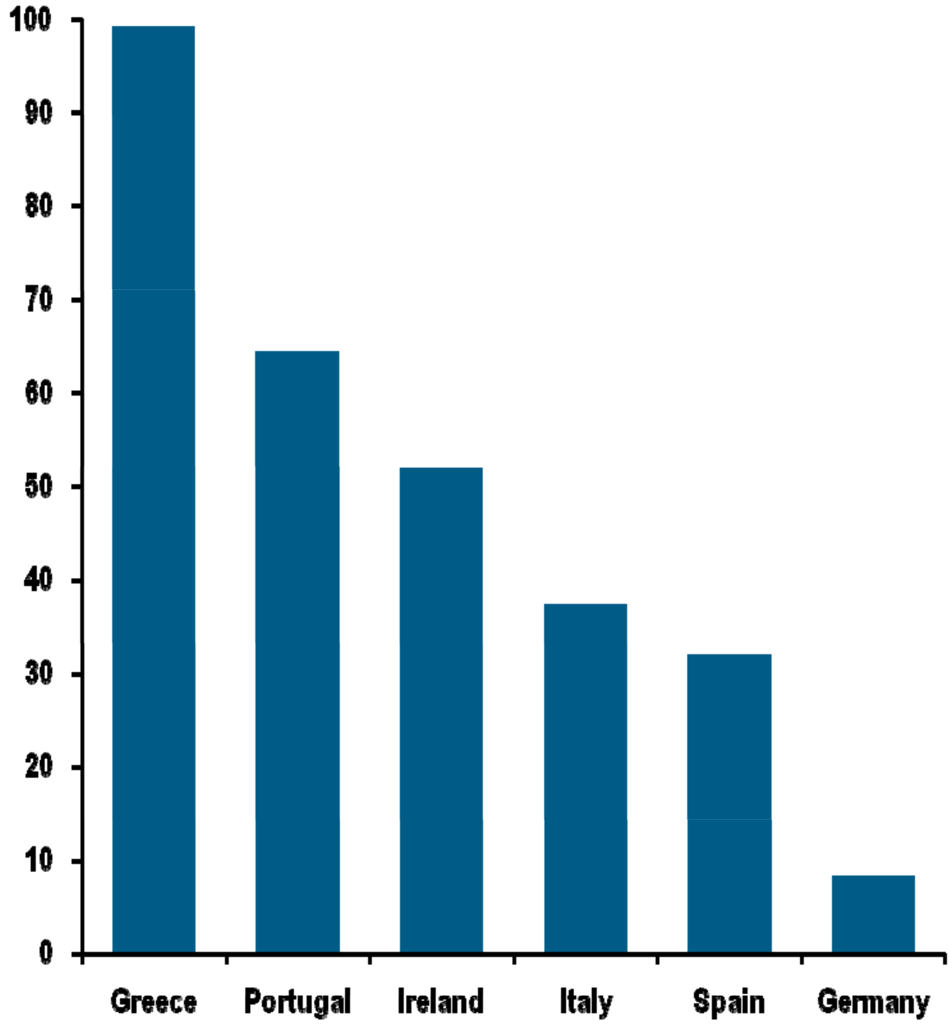
Sovereign bond markets under pressure; ECB helps

Spreads to German Bunds, %



It's now priced in – Greece will default soon

CDS-implied probabilities of default (5Y horizon, %)



Sources: Datastream, Bloomberg

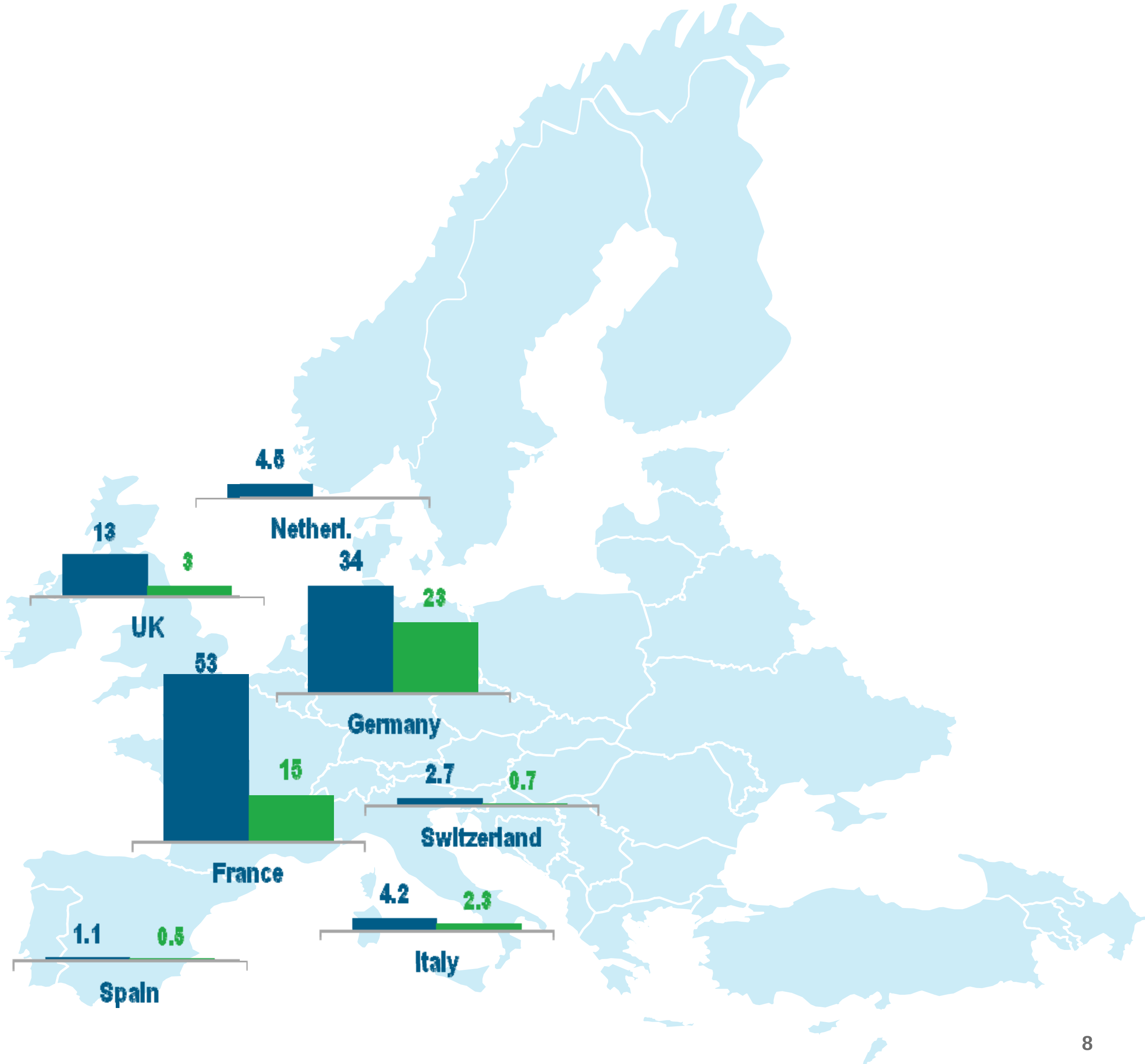
Greece – To default or not to default?

- The July 21 Greece bailout package of EUR 109bn is a positive step in the right direction but implementation has been slow
  - Voluntary participation in a debt exchange, but no new money involved
  - New (exchanged) bonds are priced to produce a 21% Net Present Value loss
  - EFSF lending capacity to increase from EUR 255mn to EUR 440mn
  - EFSF authorized to buy government bonds in secondary market and recapitalize banks
  - But implementation of structural reforms in Greece is delayed
- Cost of a default is high
  - Immediate cut-off from any funding source
  - Greek banks would have to be recapitalized (holding EUR 49bn of govt debt)
  - Next bond redemptions are on Dec 19 (EUR 8.3bn due in 2nd half of Dec)

Bank Exposure to Greece not excessive – but creates uncertainty

Country	Total claims (USD bn)	Claims on public sector (USD bn)	Total claims as % of bank assets
France	53	15	1.1%
Germany	34	22.7	0.6%
UK	13.1	3.4	0.2%
Portugal	10.2	n.a.	3.4%
Netherl.	4.5	n.a.	0.3%
Italy	4.2	2.3	0.2%
Austria	3.1	n.a.	0.5%
Switzerland	2.7	0.7	0.1%
Belgium	1.9	1.8	0.4%
Spain	1.1	0.5	0.0%
Non Europe			
US	7.4	1.5	0.1%
Japan	1.4	0.4	0.0%

Source: BIS (as of Q1-2011)



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Outlook: fragile environment for the euro area

- Downside Risk: Escalation of peripheral crisis
  - Euro-area scepticism / bailout fatigue rising (northern euro area)
  - No consensus on issuance of Eurozone Common Bonds
  - Austerity fatigue in periphery
  - Risk of a disorderly Greek default – with threat of contagion to other countries
  - Confidence deterioration – interbank market freezing
  - Further delays cause investor anxiety
- What needs to be done?
  - Isolate Greece's problems – orderly restructuring – prevent contagion
  - Prevent a freeze of interbank USD liquidity
  - ECB to provide massive liquidity / monetary easing - ECB longer-term refinancing operations are helpful
  - Preventive Bank Recapitalization

Our Bank's forecasts – *as of 7 October 2011*

Country	GDP growth			CPI inflation			FX (vs. USD)				
	2011F	2012F	2013F	2011F	2012F	2013F	Q4-11	Q1-12	Q2-12	Q3-12	Q4-12
Euro area	1.8	1.3	2.3	2.6	1.9	1.9	1.28	1.30	1.35	1.38	1.42
UK	1.1	1.9	2.3	4.3	2.2	1.9	1.48	1.51	1.55	1.60	1.65
Switzerland	1.9	1.6	2.4	0.4	0.7	1.1	0.94	0.93	0.96	1.00	1.05
US	1.6	2.0	2.5	1.6	1.9	1.8					
China	9.3	10.0	9.8	5.1	4.8	5.4	6.31	6.24	6.18	6.12	6.06

Country		Rates forecasts					
		Q4-11	Q1-12	Q2-12	Q3-12	Q4-12	Q1-13
Euro area	Policy rate	1.25	1.00	1.00	1.00	1.25	1.50
	10Y bond yield	1.70	1.80	2.00	2.25	2.35	2.45
UK	Policy rate	0.50	0.50	0.50	0.50	0.50	0.75
	10Y bond yield	2.15	2.20	2.30	2.40	2.50	2.60

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