The Sovereign Debt Crisis
How will banks be affected?

Management Information Meeting
Erste Group

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Josef Christl

Can recession be avoided?

(real GDP growth in %)

	2009	2010	2011	2012f	2013f
Euro area	**-4,1**	**1,7**	**1,5**	**0,2**	**1,2**
Germany	-4,6	3,5	3,0	0,7	1,5
France	-2,5	1,5	1,5	0,4	1,2
Italy	-5,2	1,2	0,2	-1,0	0,0
Austria	-3,8	2,3	3,3	0,9	2,0
Spain	-3,7	-0,1	0,7	-1,7	-0,3
Portugal	-2,5	1,3	-2,2	-3,0	0,1
Greece	-2,3	-4,4	-5,5	-3,0	0,5
US	**-3,5**	**3,0**	**1,6**	**1,8**	**2,0**
Japan	**-6,3**	**4,4**	**-0,9**	**1,7**	**1,6**
Emerging Asia	**7,2**	**9,5**	**7,9**	**7,3**	**7,8**

Source: Erste Group Research; IMF; OECD

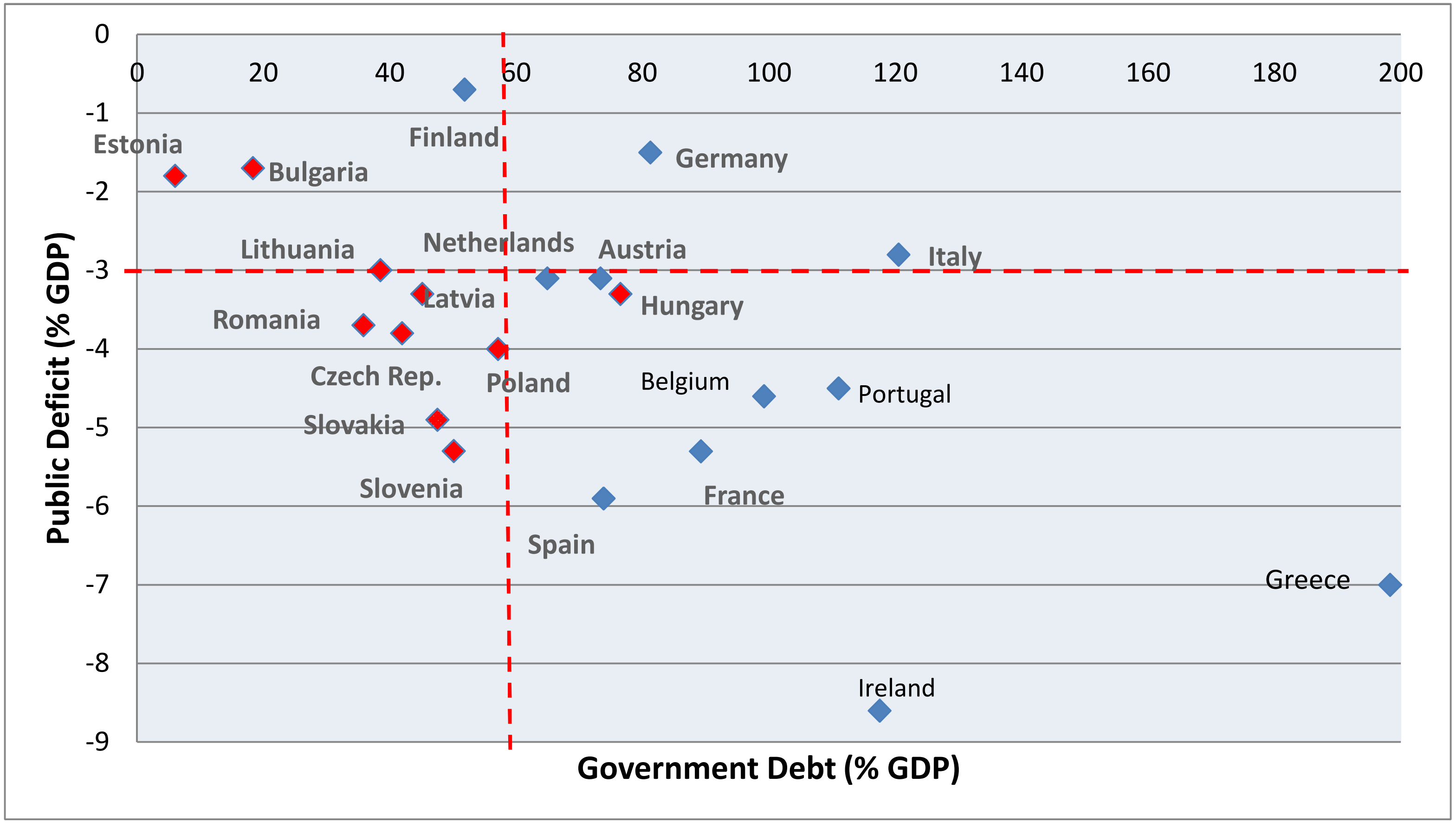
Heterogenous growth performance in CEE

(real GDP growth in %)

	2009	2010	2011	2012f	2013f
CEE8 - average	**-4,1**	**2,4**	**3,1**	**1,1**	**2,8**
Croatia	-6,0	-1,2	0,3	-1,0	1,0
Czech Republic	-4,1	2,6	1,6	0,0	2,0
Hungary	-6,7	1,3	1,6	-0,5	1,5
Poland	1,6	3,8	4,3	2,4	3,2
Romania	-7,1	-1,6	2,5	1,2	2,9
Serbia	-3,5	1,0	2,0	1,0	2,5
Slovakia	-4,8	4,2	3,0	1,0	2,5
Ukraine	-14,5	4,2	4,9	1,0	5,0
CEE8 + Turkey	**-4,4**	**4,7**	**5,0**	**1,6**	**3,4**
Turkey	-4,8	8,9	8,5	2,5	4,5

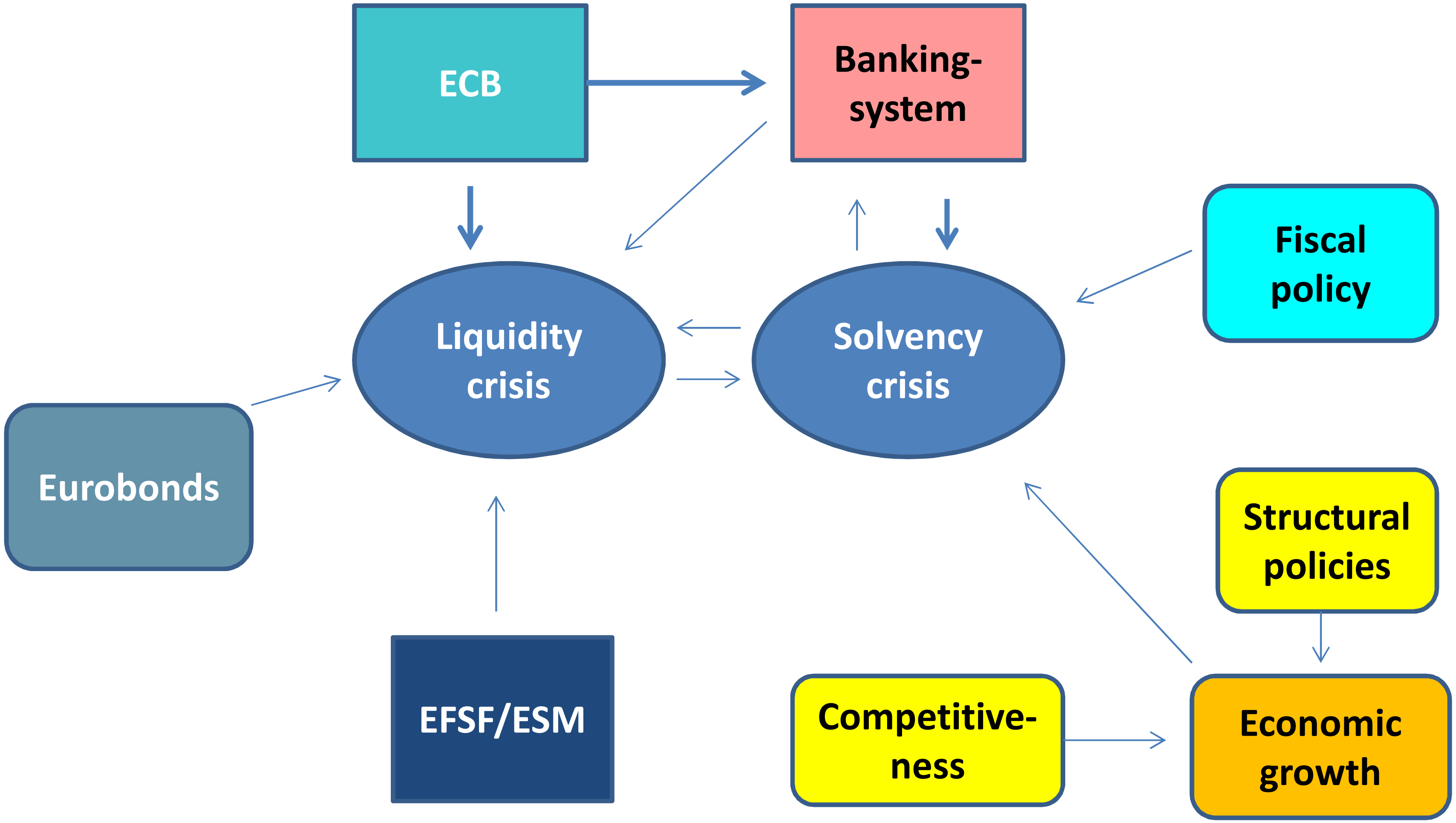
Source: Erste Group Research, IMF

CEE-fiscal postion clearly better than in the Euro area (2012f)



Source: EU Comission, Autumn Forecast 2011

Twin Problems: Solvency and Liquidity



A series of rescue packages, …..

Greece 1 (May 2010)
110bn EUR (Euro area 80 bn bilateral loans + IMF 30 bn EUR)

Greece 2 (July 2011, February 2012)
130bn EUR till 2014 (EFSF + IWF); Private Sector Involvement (PSI), hair cut 53,5%; lower interest rates, repayment extended. Loss in NPV close to 70%.

EFSF - European Financial Stability Facility (June 2010)
originally 440 bn EUR, upgraded in 2011 to 780 bn EUR in order to increase credit capacity to 440 bn EUR + EU Commission special credit line of 60 bn. EUR + IMF 250 bn EUR

ESM – European Stability Mechanism (July 2011)
will replace EFSF in mid 2012; loan capacity up to 500 bn EUR (cash payments of 80bn EUR + 620 bn EUR guarantees)

….several EU summits: Only modest success! (1)

October 26 -27, 2011

- **Debt restructuring Greece**
  Private sector involvment (haircut 50%), no official sector involvement;
  targeted: debt lever 120% of GDP in 2020.

- **Banking package**
  - 9% core-tier 1 for European SIFIs until end of June 2012 after accounting for market valuation of sovereign debt;
  - ensure medium term funding via guarantees in order to avoid a credit crunch;
  - financing first via private sources of capital, constraints to dividends and bonus until target is reached, if necessary loan from the EFSF.

- **Leveraging the resources of the EFSF**
  providing credit enhancement or generating new funding sources („China“)
  combining from private and public capital through special surpose vehicles.

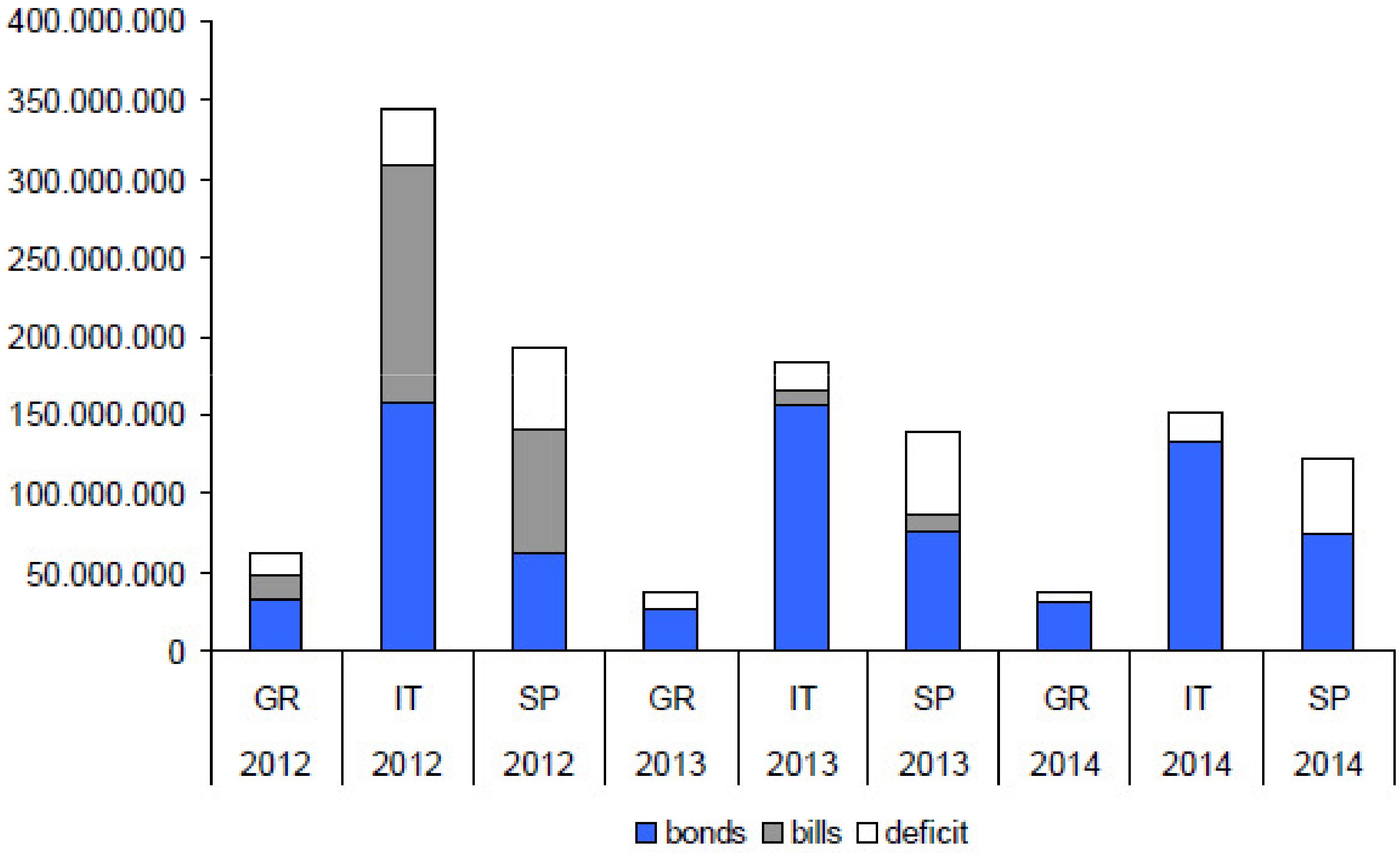
- **Budget consolidation and structural reforms in Italy and Spain**

….several EU summits: Only modest success! (2)

December 9, 2011

- **New fiscal compact and stronger coordination of economic policies**
  - fiscal rules introduced at constitutional or equivalent level in each member state;
  - structural deficit not higher than 0,5% of nominal GDP;
  - monitoring of budget plans by Commission and in the case of non-compliance request of revision;
  - rules governing excessive deficit procedure reinforced: adoption of automatic consequences in case of a violation of the 3% deficit ceiling, unless a qualified majority is opposed;
  - further fiscal deepening in the longer term.
- **ESM Treaty to enter into force already in June 2012**

The Liquidity Problem: High Refinancing Needs



Source: Bloomberg, Erste Group Research

Stability Bonds (Eurobonds): Proposals of the European Commission

Green Paper on the feasibility of introducing Stability Bonds. European Commission, November 2011, Brussels.

Options for guarantees

1. Several (not joint) guarantee structure with enhancements (e.g. according to ECB capital key) – will not receive AAA rating.
2. Joint and several guarantee structure - would breach Article 125 of the Treaty; could be rated AAA

Options for issuance

1. Full substitution for national issuance;
   would secure funding without dependence of the fiscal situation – high danger of moral hazard;
2. Partial substitution;
   Blue bonds/Red bonds Proposal of Bruegel: market is split in two segments; but less danger of moral hazard
3. Partial substitution and not joint guarantee; low danger of moral hazard

Eurobonds: a way out?

Advantages

- **More resilience of the financial system and higher financial stability (secure access to refinancing, less volatility);**
- **More robust collateral for all euro area banks reducing their vulnerability;**
- **Facilitate the transmission of monetary policy;**
- **Improving market efficiency in the soveign bond market (large and highly liquid market, single „risk free“ bench mark yield)**
- **Enhancing the role of the Euro in the global financial system (strengthening of the Euro as a reserve currency)**

Disadvantages

- **moral hazard (could lead to less budgetary discipline)**
- **Substantial changes in the economic governance of the Euro area necessary (additional safeguards for fiscal discipline)**
- **Need to have highest credit quality (rating) to be accepted by investors**
- **High transparency to allow investors the pricing of the underlying guarantees**
- **Redistribution of funding advantages between member states**
- **Issuance under joint and several guarantee requires changes in the relevant provisions of the Treaty (Article 125 „no bail-out clause“)**

Source: Green Paper on the feasibility of introducing Stability Bonds. European Commission, November 2011, Brussels.

ECB: Lender of Last Resort for Banks - and Sovereigns?

Basic mandate: price stability

Subordinated mandate: financial stability

During crisis additional tasks

- **Proper functioning of euro money markets**
  unconventional measures of monetary policy, e.g. 1year and 3-year LTRO, USD swap lines aso.
- **Proper functioning of sovereign debt markets:** Securities market programme based on Art. 18 ECB-Protocoll, possible conflict with Art 123 AEUV. 3-year LTRO
- **Maintaining refinancing of the banking system in crisis countries:**
  e.g.Broadening of collateral basis

Considerable credit and credibility risks!!

The Solvency Problem: a simple analysis of debt sustainability

Required primary balance to stabilize the debt/GDP ratio:

$$PB \geq (i - g)\ D$$

PB = primary balance
i = average nominal interest rate on government debt
g = growth rate of nominal GDP
D = government debt in % of GDP
PB – i.D = fiscal deficit

Example: Greece (after PSI of 107bn EUR):
Given a “new” debt level of 300bn EUR (148% of GDP), an average nominal interest rate on government debt of 3%, nominal GDP growth of 1 %, a primary balance of 3,0 % of GDP would be necessary in order to stabilize the government deficit at 110 % of GDP.

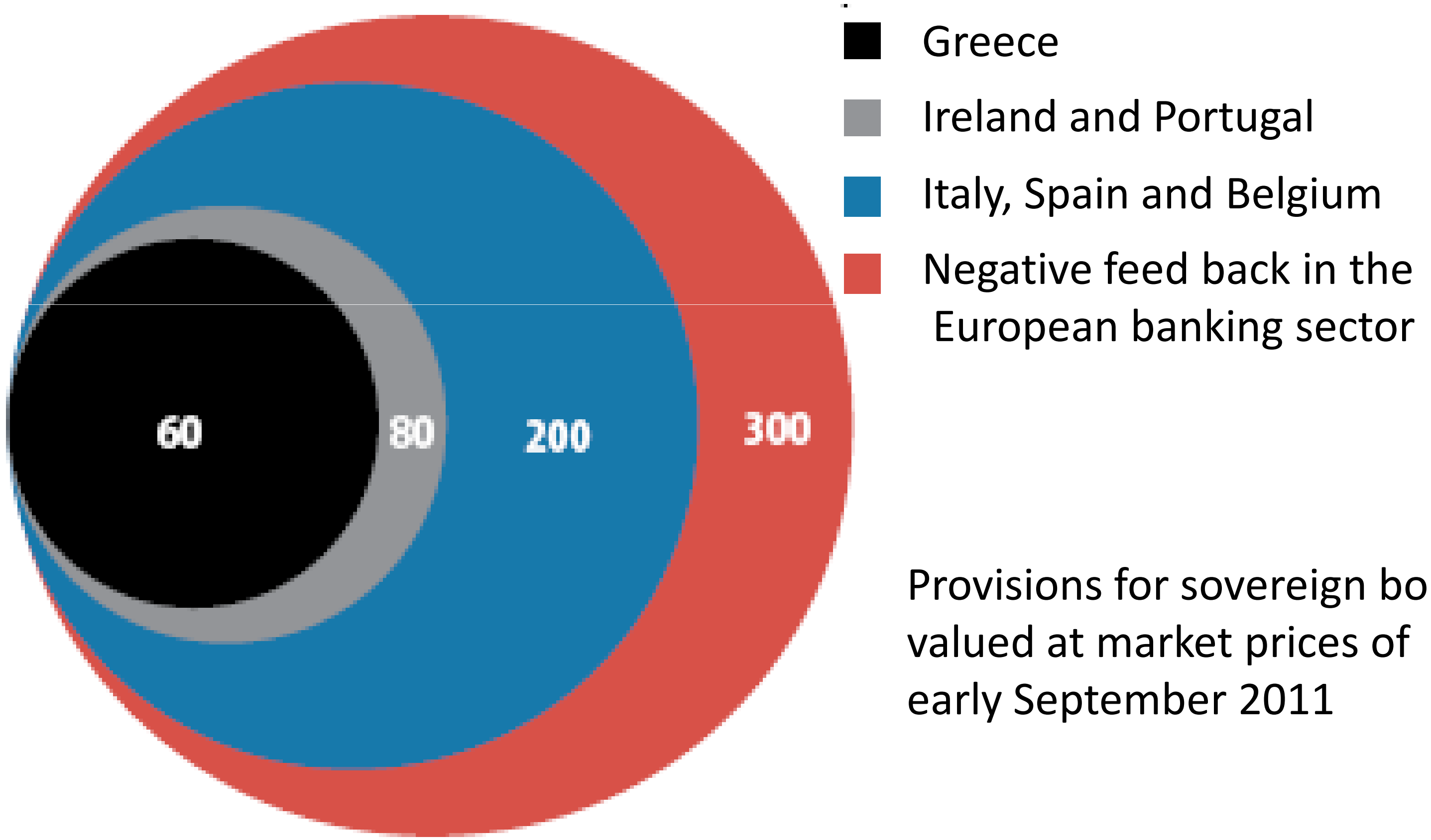
Can debt levels be stabilized?

	Debt % of GDP, 2011	Interest rate government debt, % 2012-15	nom. GDP growth, % 2012-15	required primary balance, % of GDP 2012-15	Forecast of primary balance 2012-15
Greece*) before PSI	**163**	**4,5**	**1,0**	**+5,5**	**0,0**
Italy	**120**	**4,6**	**2,0**	**+3,1**	**+1,0**
Ireland	**108**	**4,3**	**3,5**	**+0,9**	**-2,0**
Portugal	**102**	**5,0**	**2,5**	**+3,1**	**-0,5**
Spain	**70**	**4,2**	**3,0**	**+1,2**	**-3,0**

Source: EU-Comission (2011), IMF (2011), Macro-Consult

Considerable Spill-overs to the Banking System

bn EUR

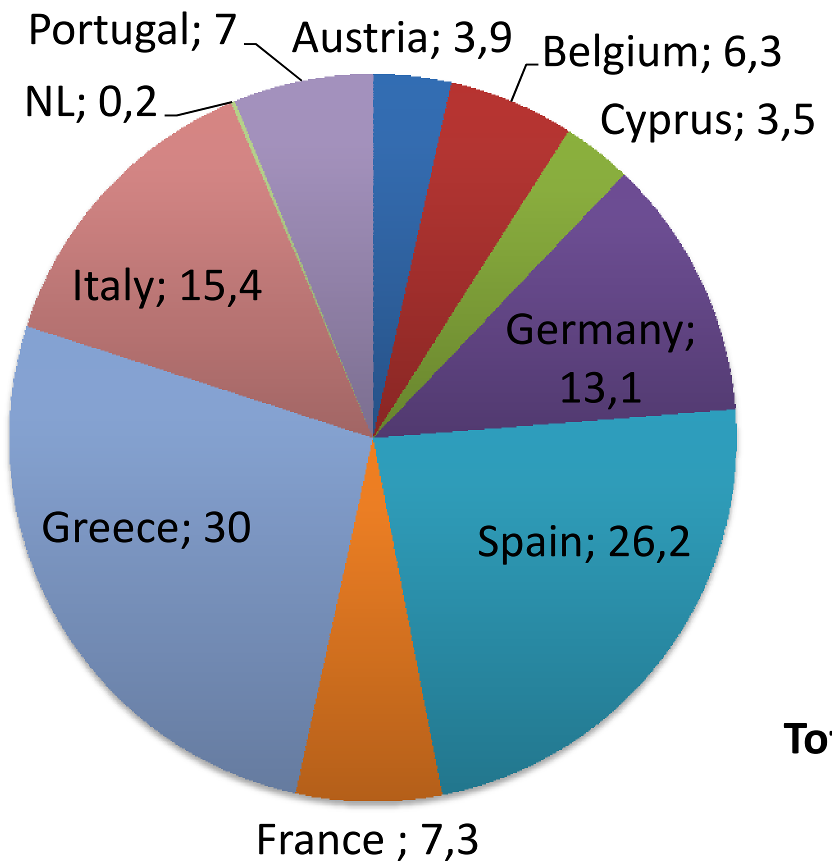


Provisions for sovereign bonds valued at market prices of early September 2011

Source: IMF, GFSR, 2011

Bank recapitalizations: risk of accelerating the crisis

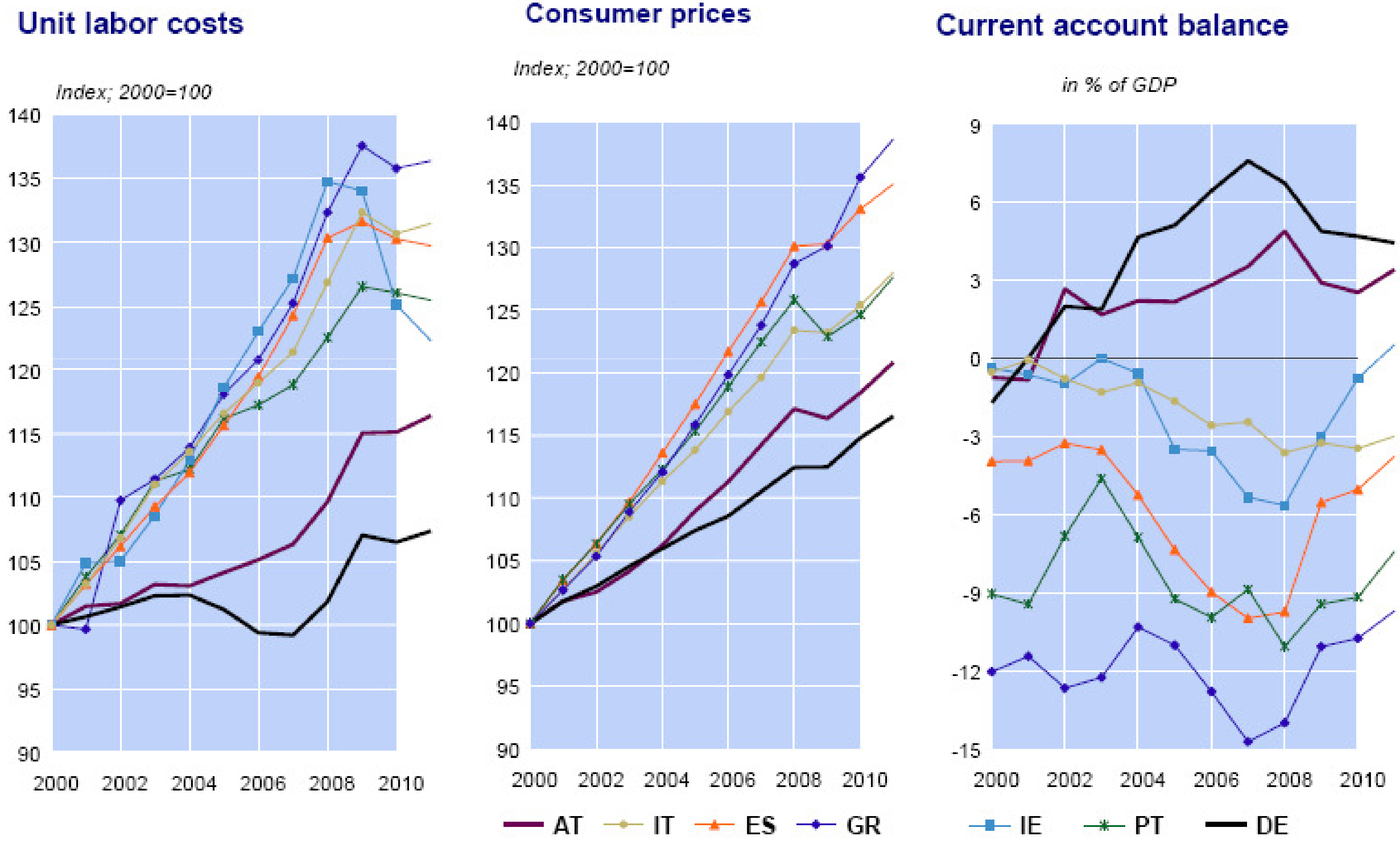
(Capital shortfalls as calculated by EBA in December 2011, in bn EUR)



Total: 114,7 bn EUR

Source: European Banking Authority, December 2011

Diverging Competitiveness – cruical issue for solvency problem!



Source: EU-Commission, 2011

What does economic theory tell us?

Necessary conditions for an optimum currency area (OCA)	
1. **Open economies with strong trade links**	fullfilled
2. **Liberalized capital, labour and procuct markets**	fullfilled
3. Correspondence or rapid convergence of **economic structures** (e.g. competitiveness, labour markets, competition, pension systems, standard of living)	not fullfilled
4. Conformity in the **business cycle** (and in reaction to asymmetric shocks)	partly fullfilled
5. **Fiscal union** in order to correct for negative effects of asymmetric shocks	not fullfilled

Conclusions (1)

- **In the short-run solution** to the sovereign debt crisis (solvency problem) not in sight and **not possible**. Volatility will remain high!

- **Present architecture of EMU promotes „moral hazard“:** default risks are a matter of common policy, fiscal policy is a national matter. Strong conditionality not easy to implement.

- **Risks for a political backlash** (e.g. Greece, but also Italy) **increase!**

- European politics have mainly adressed the liquidity problem. **Attempts to promote growth** via structural policies have been very **poor so far** (and sometimes counter productive – e.g. banking recapitalisation)

- **Measures taken by EU summits** are often **not specific enough** and turn out as non-viable or have to be corrected. Credibility problem for politicians.

Conclusions (2)

- The **most effective crisis manager** has been **the ECB**, taking high risks in it‘s balance sheet as well as for it‘s independence and credibility!

- Progress in **structural reform and fiscal consolidation in Italy** will become the **decisive question for the months to come**. If Italy does not succeed, inflationary developments or a split-up of the Euro area are possible options.

- In the **medium and longer-term continous steps towards more political and fiscal union are necessary**, which would require major changes in the EU-Treaty. Politicans will have to convince their electorate!

Thank you for your attendance!