European Sovereign Crisis, what's the Outcome ?

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June 2012
Mexico

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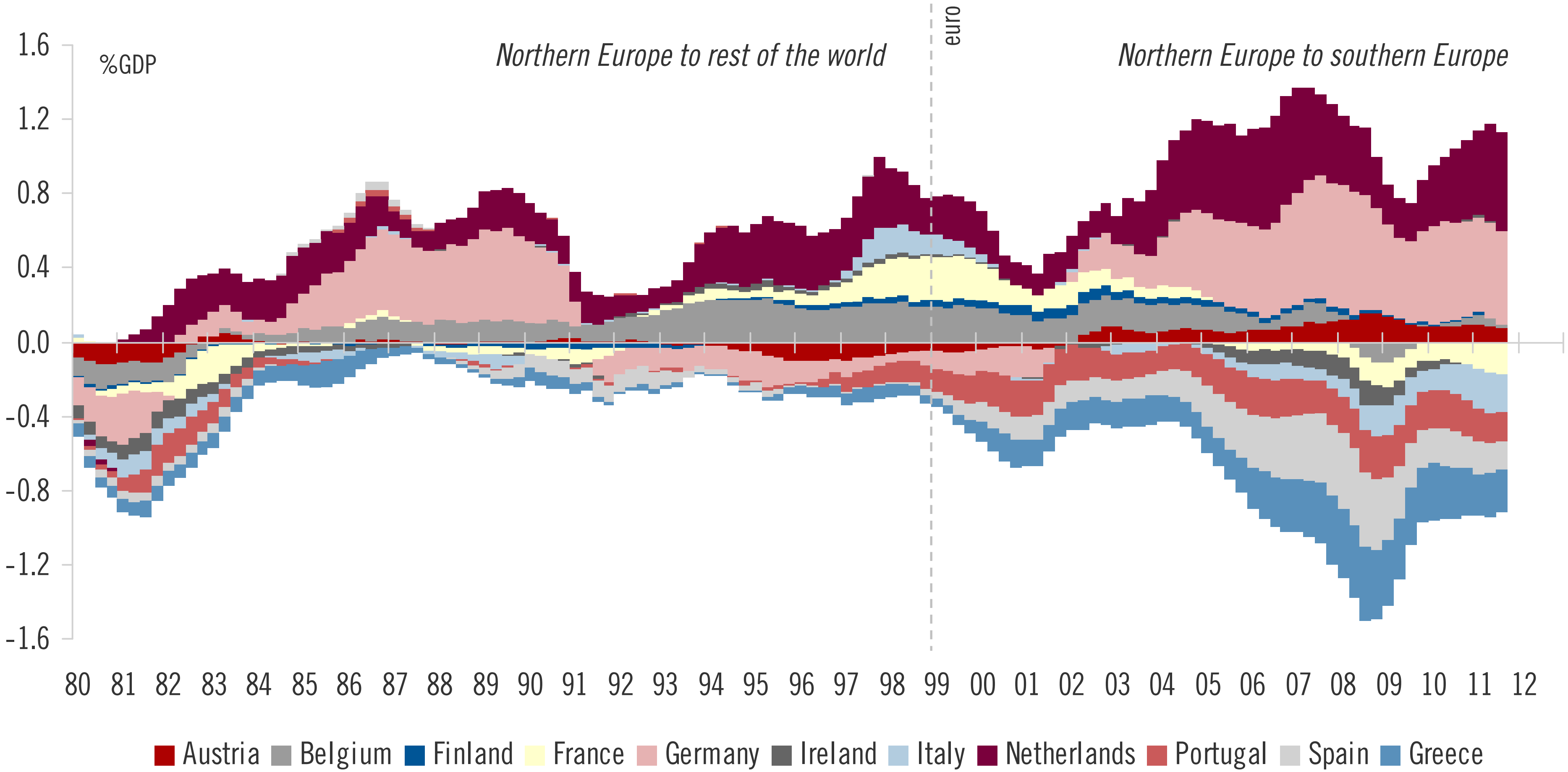
Current situation

Eurozone (im)balances: a Small World

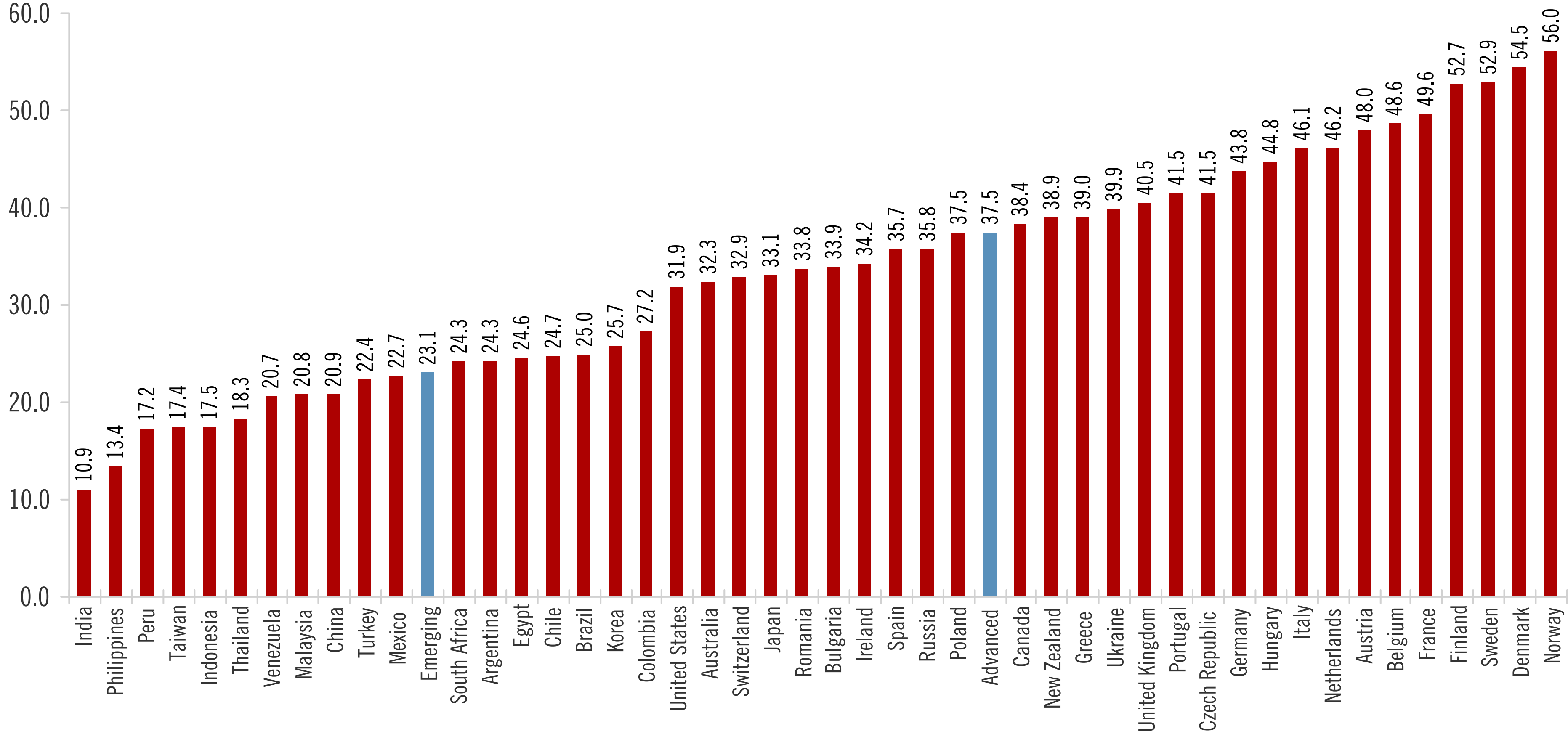
Rising imbalances since the creation of the euro

Eurozone current accounts (% Eurozone GDP) **by major EMU member**



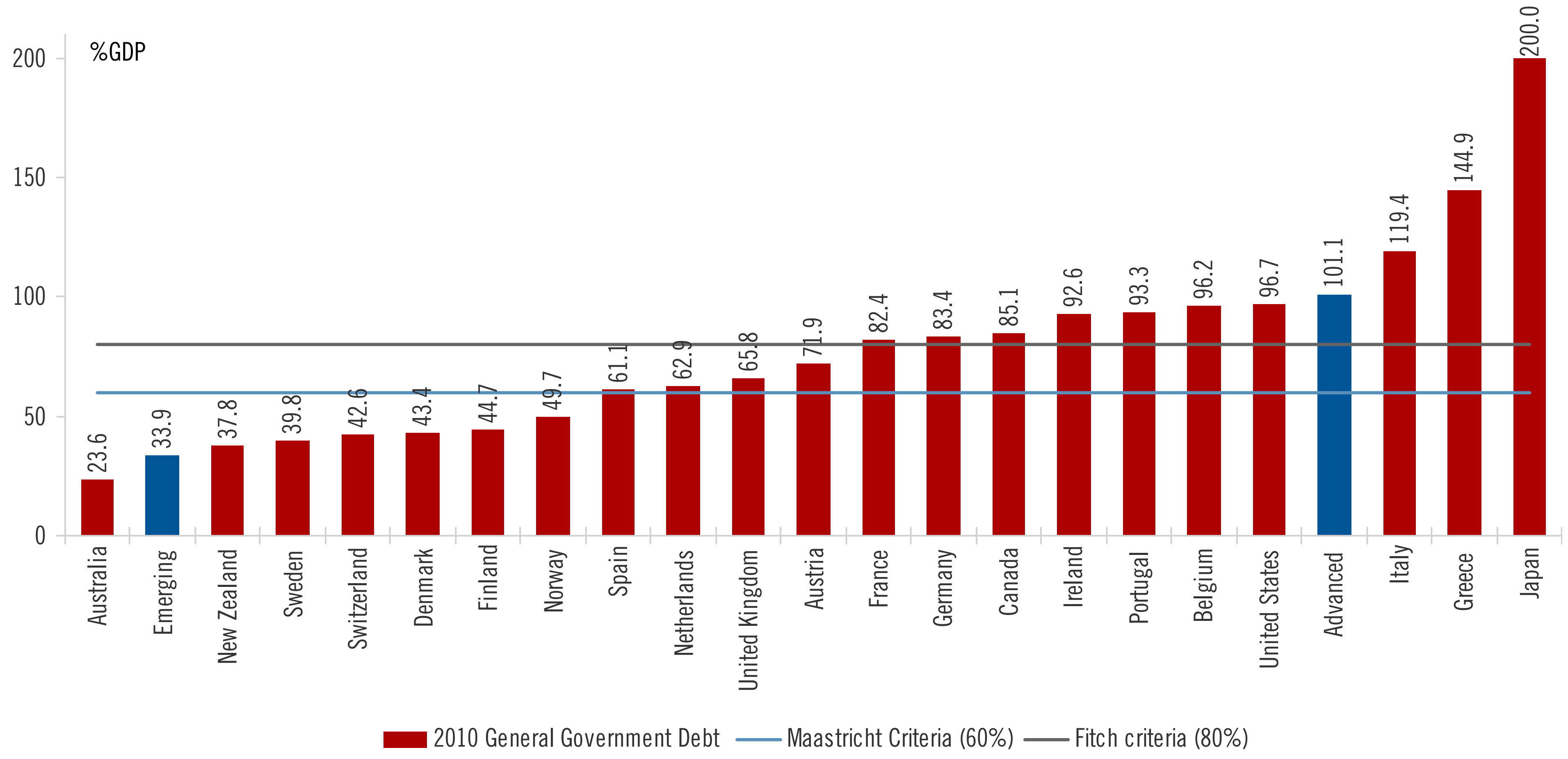
Fiscal Revenue for Advanced and Emerging Countries

Fiscal revenue to GDP ratio in 2010



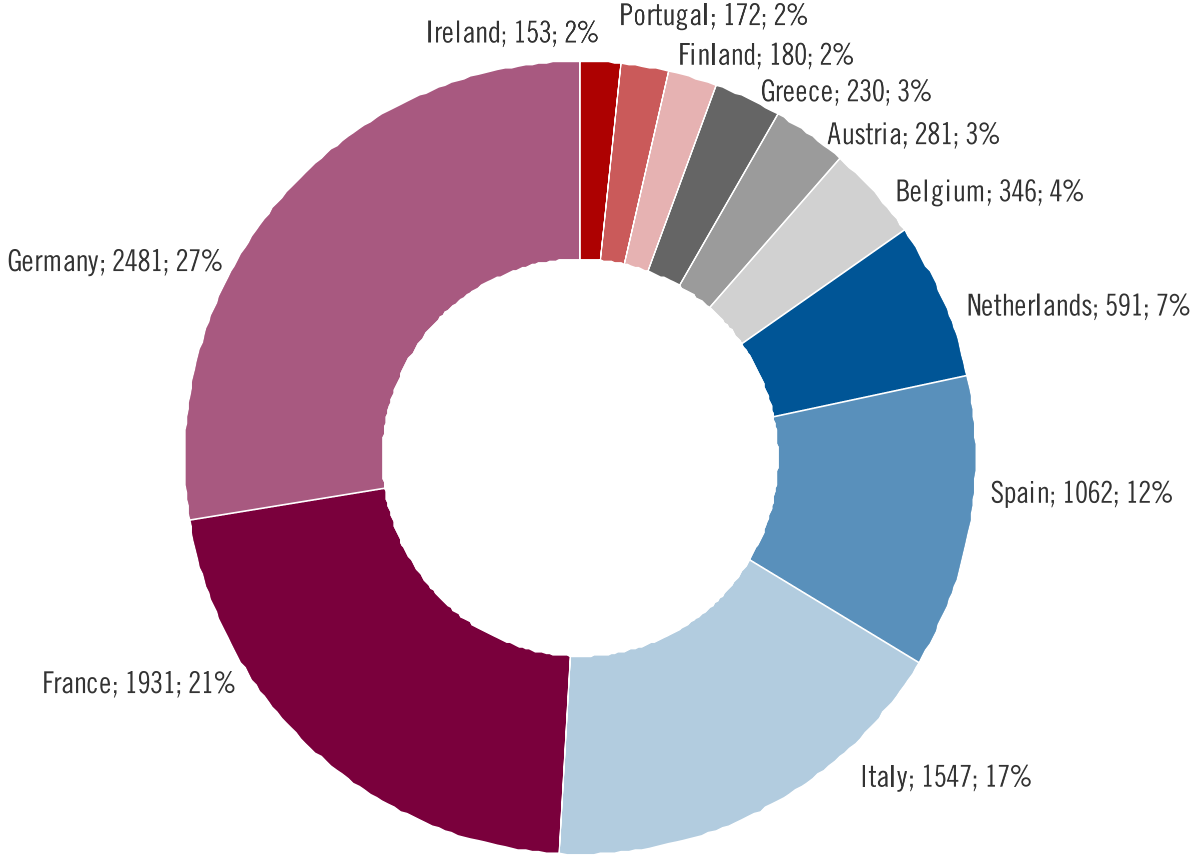
Debt-to-GDP Ratio: Developed Economies

General government debt-to-GDP ratio: major advanced (21) economies



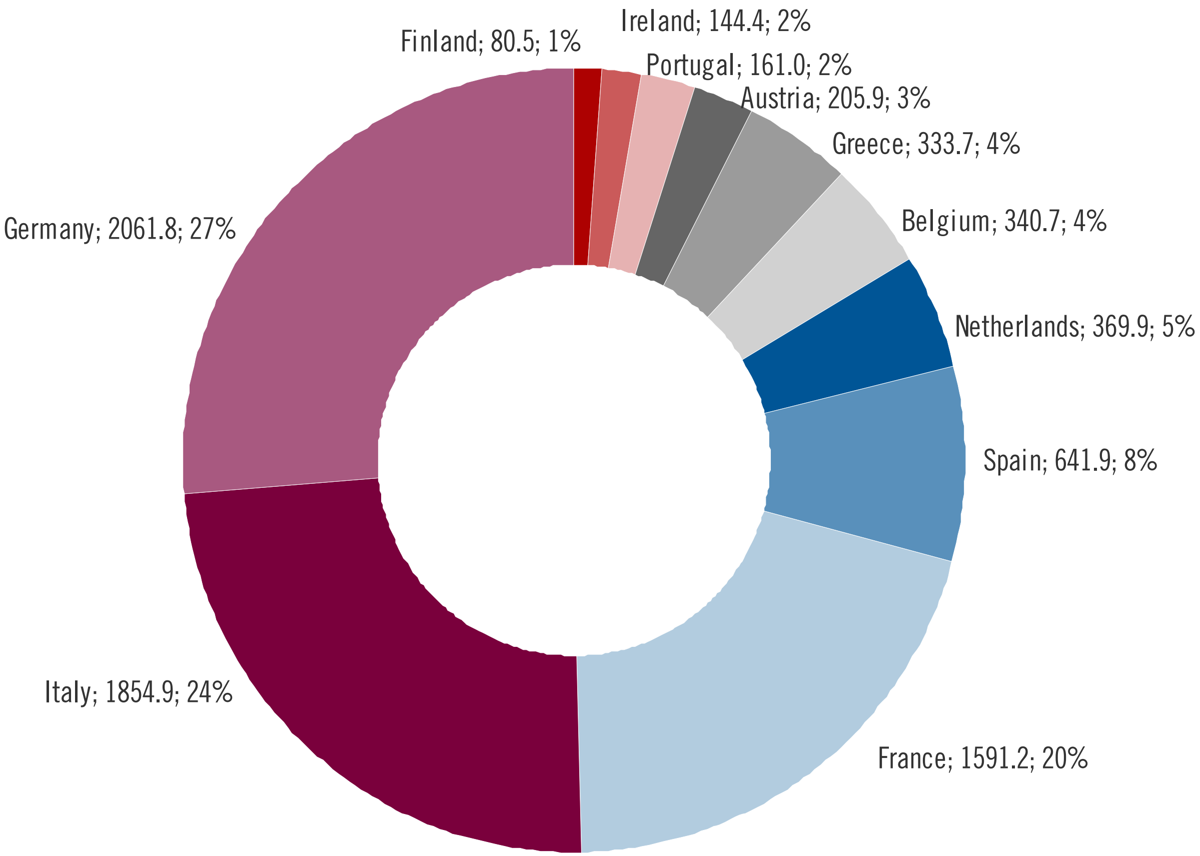
Euro Countries: GDP Shares

Eurozone countries: GDP in billion of euros and in percentage of total eurozone GDP

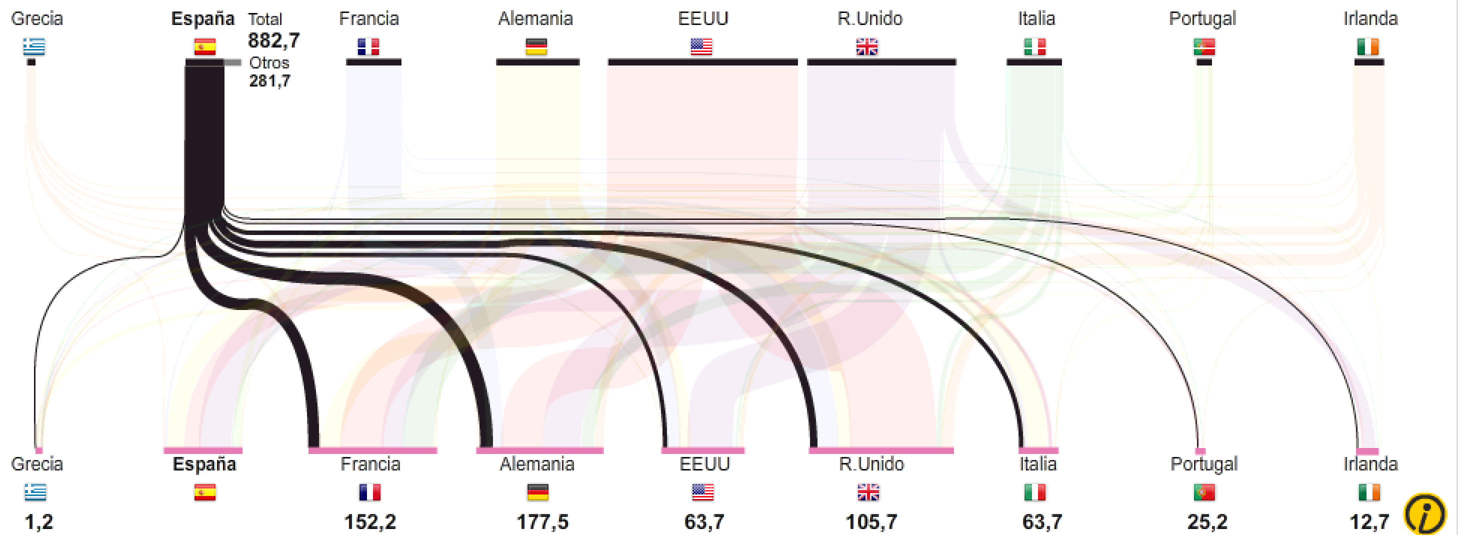


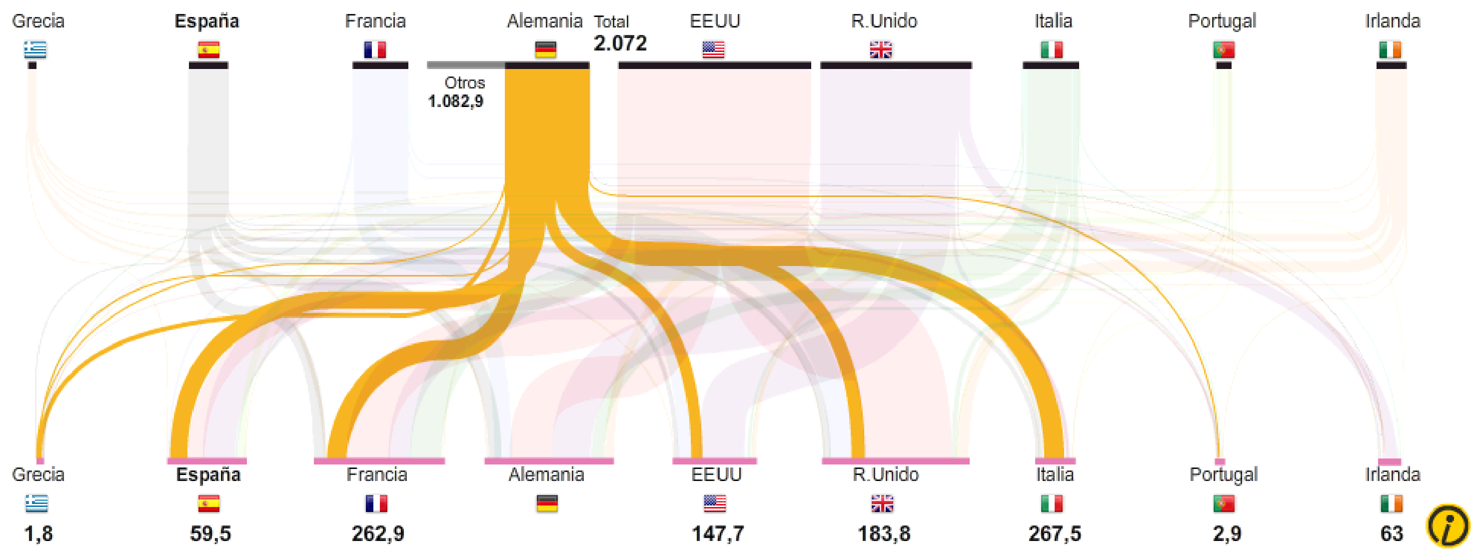
Euro Countries: Public Debt Shares

Eurozone countries: public debt in billion of euros and in percentage of total eurozone debt



Who Owes Money to Whom (USD Bn)





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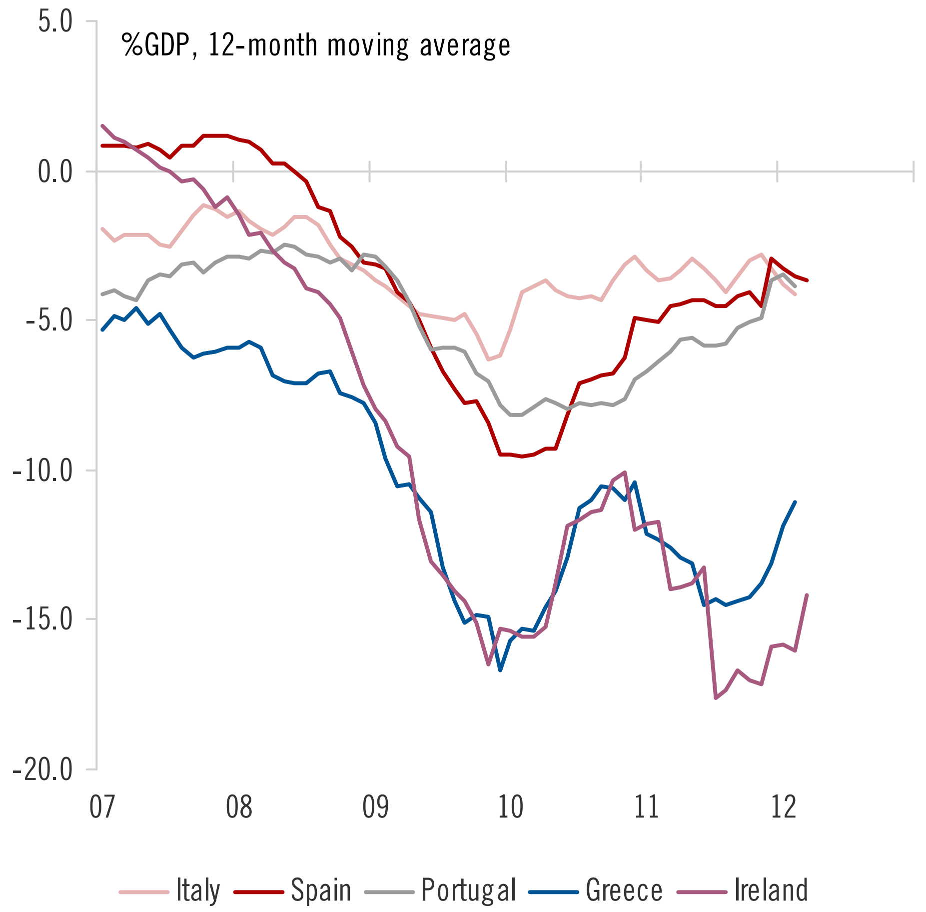
What has been done so far ?

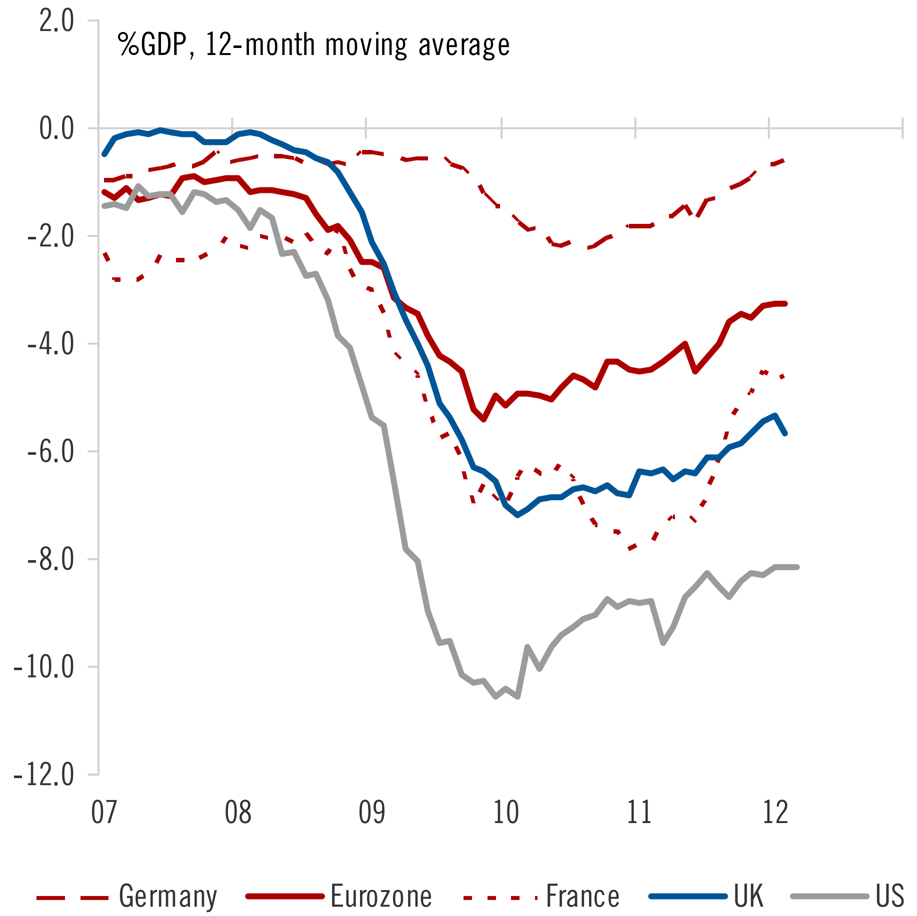
Central Government Fiscal Balance

Central fiscal balances have generally improved. Eurozone on average better than the UK & the US

Central fiscal balances: Italy, Spain & EFSF-3 countries

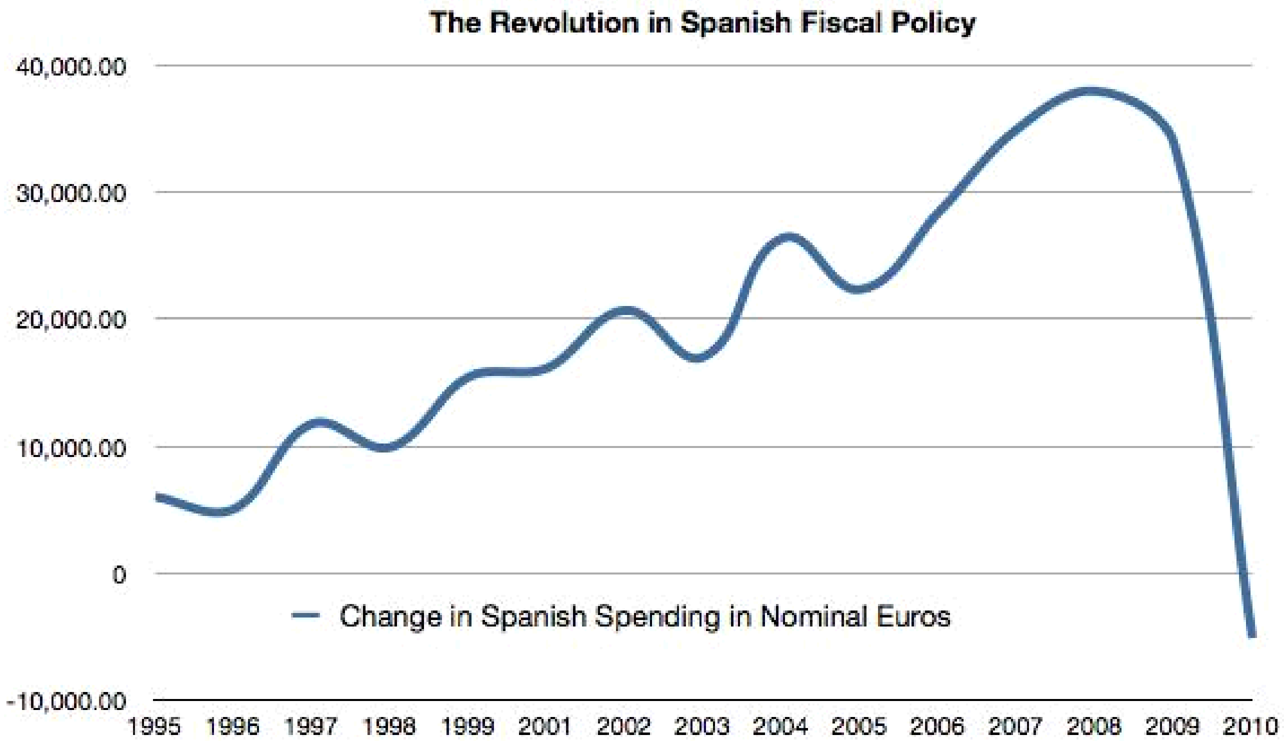


Central fiscal balances: Eurozone (average), UK & US



Source: Pictet Asset Management, CEIC, Datastream, as at 25.02.2012

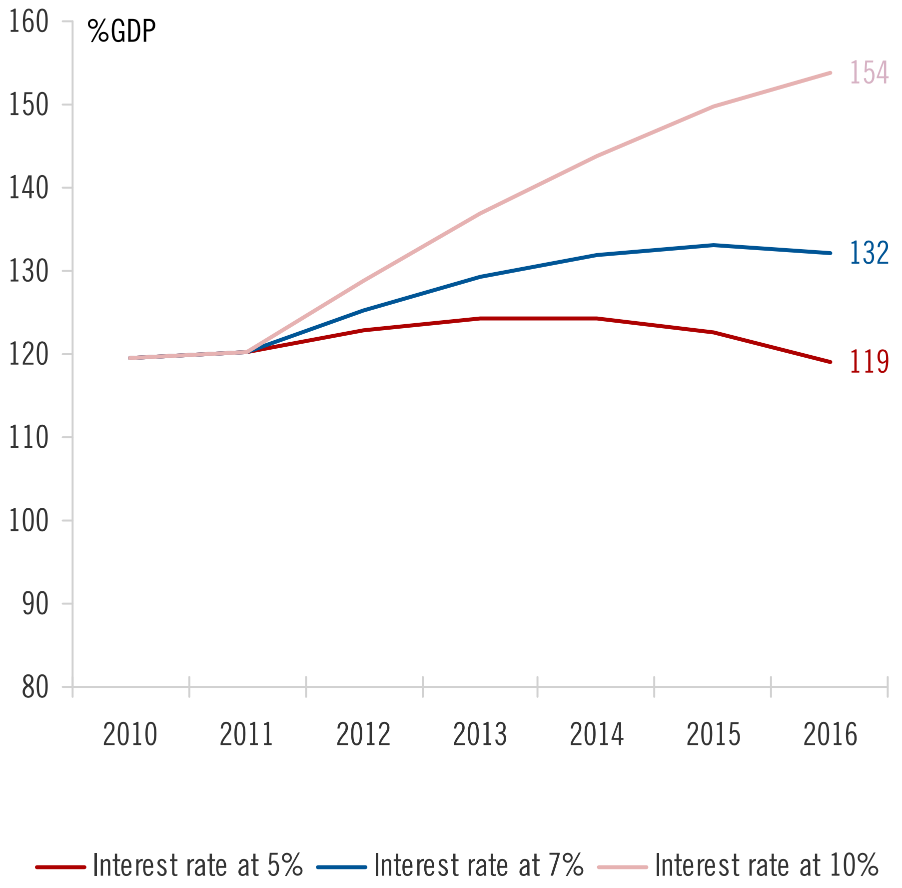
Spanish Fiscal Policy



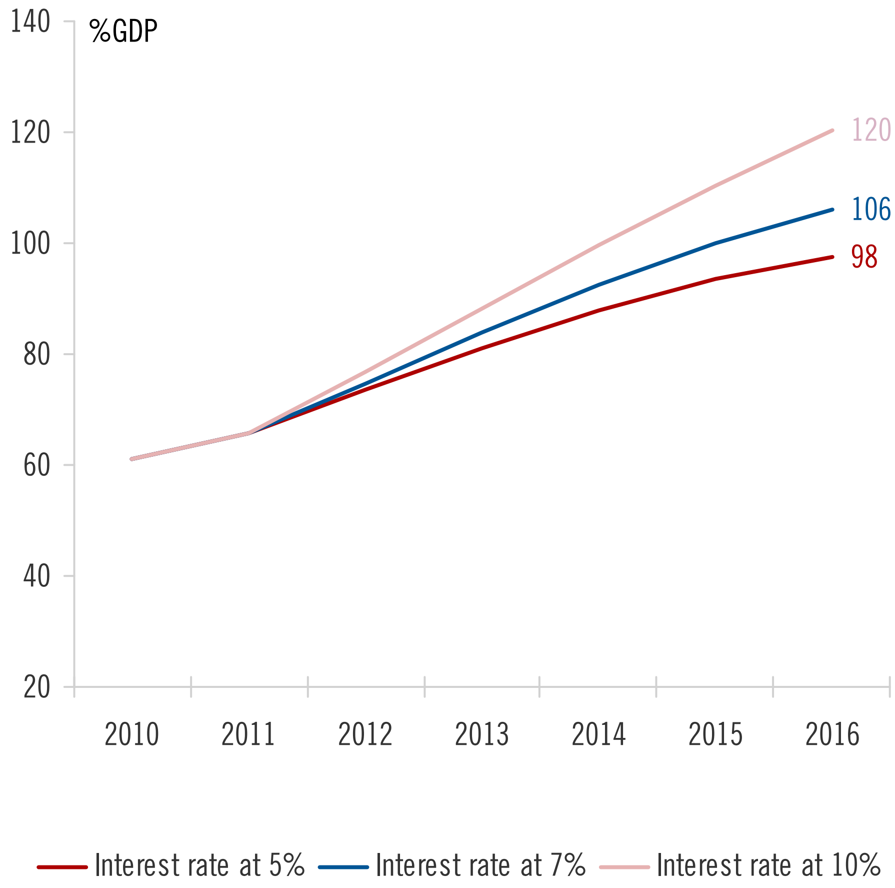
Italy & Spain debt/GDP Evolutions under Various Interest Rates

Insert key message

Italian debt/GDP simulated for various interest rates

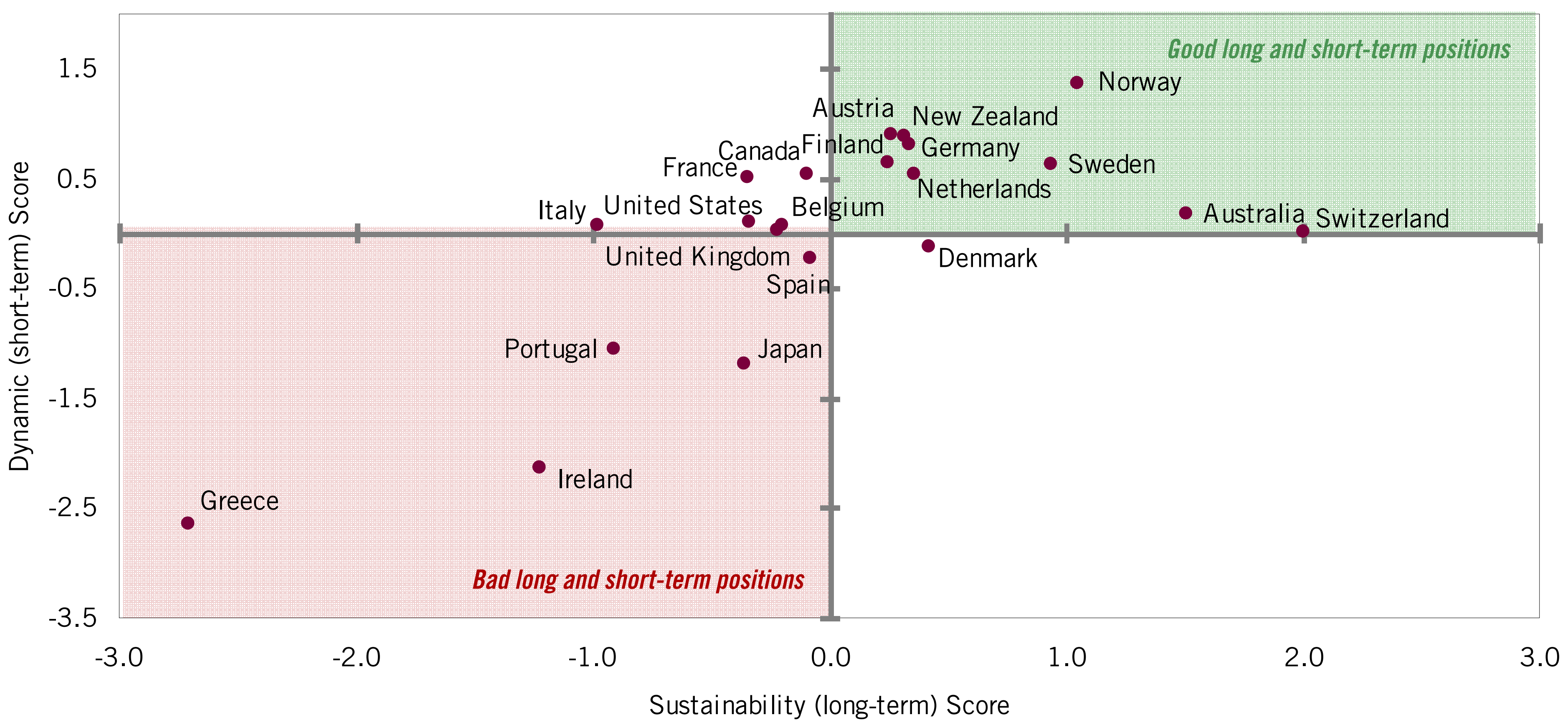


Spanish debt/GDP simulated for various interest rates

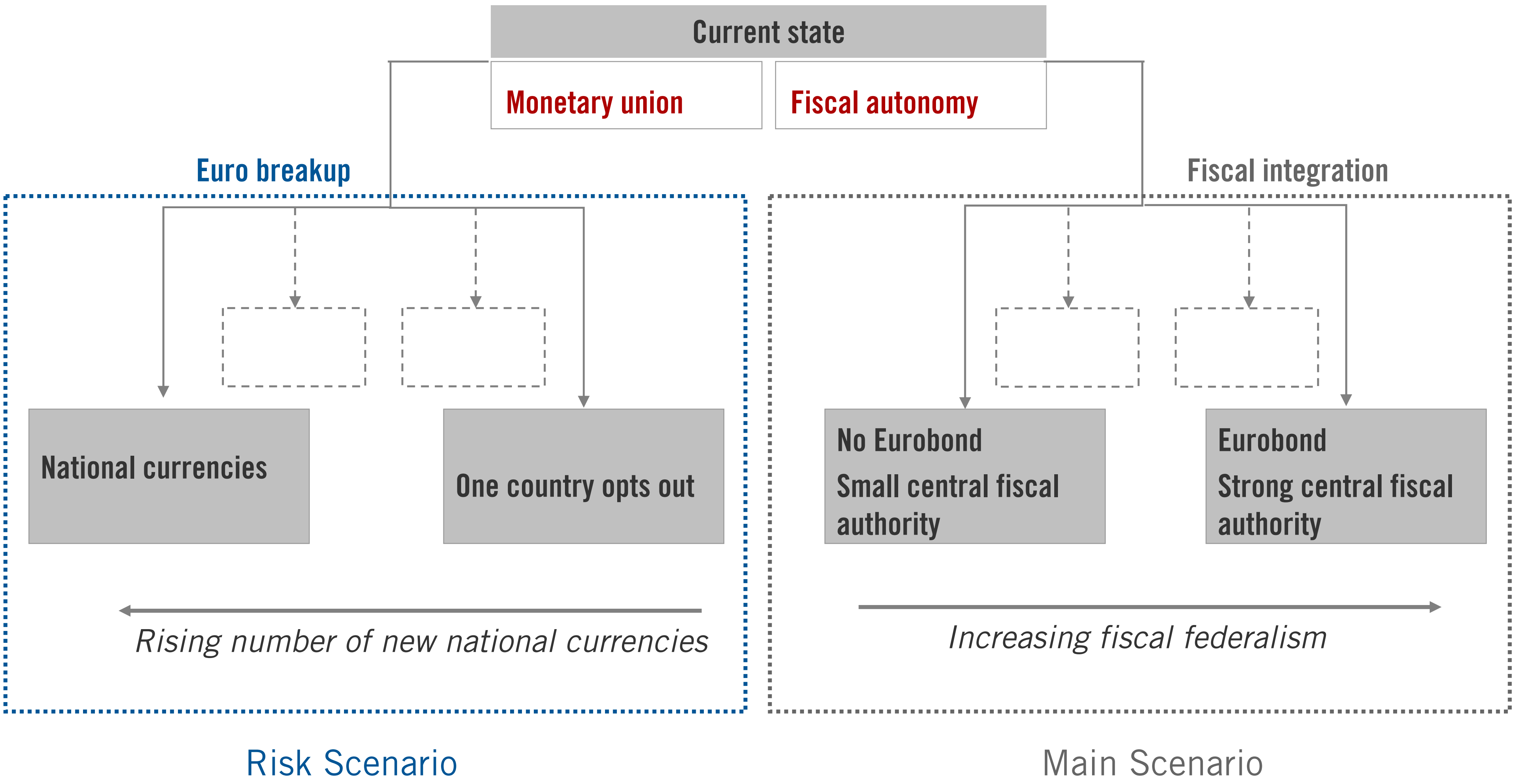


Sovereign Debt Long and Short-term Scores

Sovereign debt long and short-term scores for developed economies: a scatter diagram view



Euro Endgame: Multiple Equilibria



Source: Pictet Asset Management

Solving the Debt Problem – Four Ways Out

	High short-term cost / low long-term cost	Low short-term cost / high long-term cost		
Solution	**Debt repayment**	**Bail-out**	**Sovereign default**	**Monetization**
Debt solving mechanism	Primary balance deficit reduction	Bilateral agreements or supranational bail-out	Official default and debt restructuration	Central Bank Intervention to use the inflation channel to solve the debt problem
Domestic consequences	Lower economic nominal growth Social imbalances and conflicts between tax payers and public workers	Loss of economic independence	Limited if no access to the international market of capitals for an extended period	Loss of the Central Bank's credibility Currency depreciation
International consequences	Weaker external demand coming from the indebted country	Bilateral agreements: higher spreads for the country that funds the bail-out Possible social conflicts	Sovereign crisis contagion Banking system crisis	Competition on currency depreciation

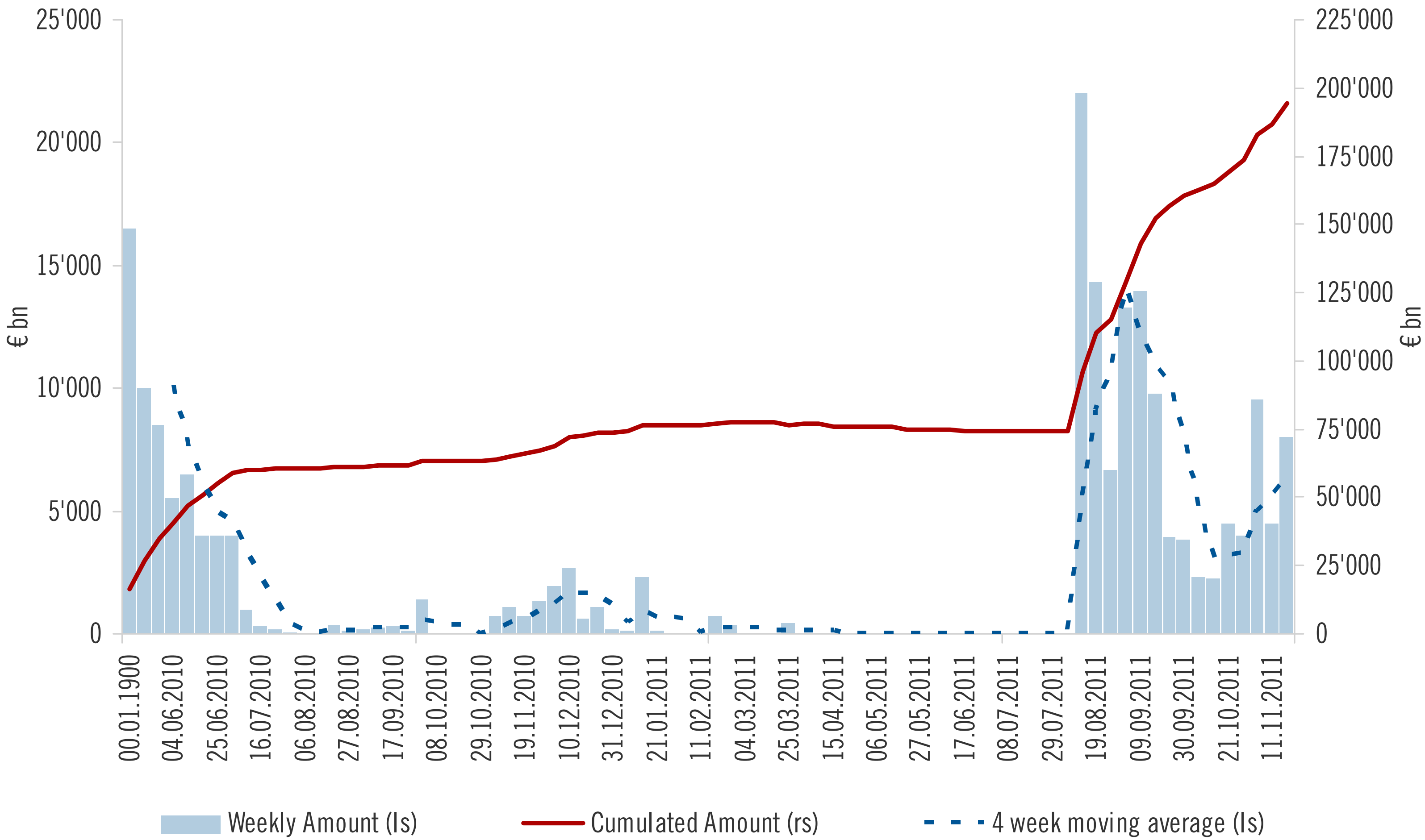
EU/IMF Financial Aid Package

Fiscal policy		Monetary policy
Greek package EUR 110bn	**Additional package EUR 720bm**	**Unconventional monetary policy tools**
– €80bn from EMU countries (funding according to countries' quotas in the ECB's capital) – €30bn from the IMF	– €60bn available under the existing European Commission balance-of-payments lending facility (Funded and guaranteed by the 27 EU members) – €440bn available through the creation of the European Financial Stabilisation Fund (EFSF) funded according to countries' quotas in the ECB's capital and guaranteed by the 16 Eurozone members – €220bn from the IMF	– Outright purchases in the Euro area public and private debt securities markets – Reactivation of 1Y, 6-month and 3-month refinancing operations at fixed rate with full allotment – Reactivation of liquidity swap lines with the Fed
– First loan tranche of €14.5bn was sent to Greece on 18th of May while second tranche of €9bn was sent on 9th of Sept. – Total package covers Greek debt service until Dec 2012 (i.e. interest payments + principal but excluding primary deficits financial needs)	– Irish package: EUR85bn EFSM/EFSF/IMF: EUR22.5bn each Domestic sources: EUR17.5bn – Portuguese package: EUR78bn EFSM/EFSF/IMF: EUR26bn each – Remaining effective lending capacity: EUR575bn (Spanish debt service is about EUR350bn until Dec 2014) – The EFSF pave the way towards a closer fiscal union in Europe	– Outright bonds purchases of €165bn (as of Oct. 14th), absorbed with one-week fixed-term deposit

ECB Government Bonds Purchase

Accelerating ECB interventions mainly focused on Italy, but to be continued with stronger commitment

ECB Eurosystem securities market program-weekly and cumulated amounts

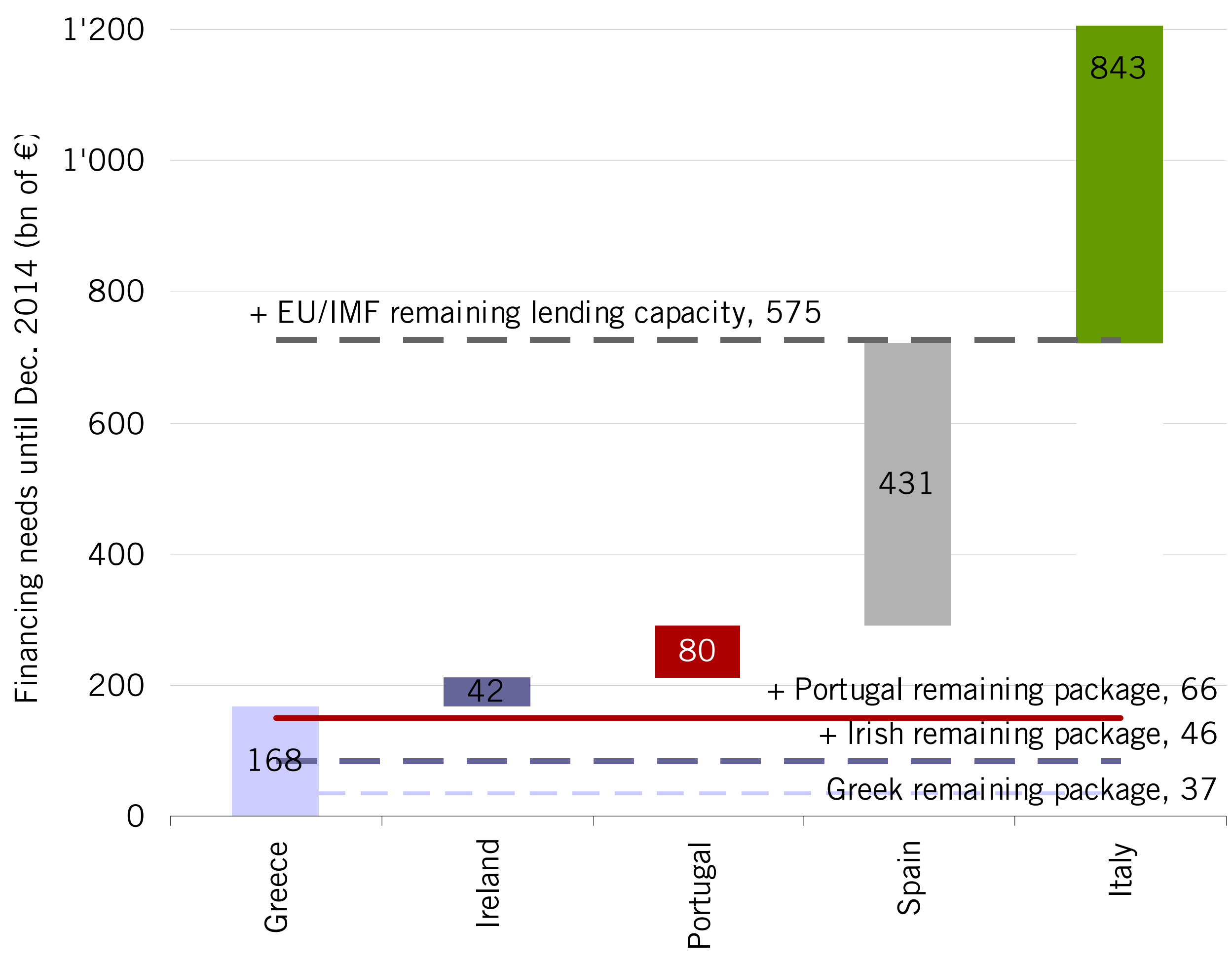


Source: Bloomberg, Pictet Asset Management. Updated 2011-10-14

EU/IMF Packages & Financing Needs for Countries at Risk

Current lending capacity just enough to cover EFSF-3 & Spain until Dec. 2014

Debt servicing until Dec. 2014 for EFSF-3, Spain & Italy & remaining packages



Euro Sovereign Risk

Themes & risks to dominate the market in the short and long run

	Main risks	Our View
Euro area	Euro breakup. Disorderly default from Greece triggering a round of contagion to other Eurozone countries and the whole banking sector.	The cost of the Euro breakup option is so high that the already started transfer between the strongest and the weakest countries will continue. More fiscal discipline and a painful adjustment process will lead to low growth over a 5 to 7 years cycle.
Greece	Disorderly default	Greece is bankrupt and by no mean can muddle through whatever the measures taken. Significant losses have to be taken through a set of orderly haircuts ultimately amounting to circa 70%.
Ireland	No stabilisation of the current negative fiscal balance trend	Ireland will have to resort to a second bailout plan in the coming months. The widely nationalised banking sector is still threatening dramatically public finances. An orderly default going forward can not be ruled out.
Portugal	Lack of growth endangering the current positive trend in terms of public finances adjustment	Portugal can muddle through but will be highly dependant on the whole zone growth and the ECB monetary policy.
Spain	Lack of growth Brutal adjustment of the real estate loans value on the banks balance sheets	Spain has made significant efforts on the fiscal front but a banking sector recapitalisation will be needed. The latter is manageable provided the real estate necessary adjustment is done gradually.
Italy	Lack of growth Government rates pushed significantly and structurally above 5%	Italy has already a primary balance almost at equilibrium. The stabilisation of its debt /GDP ratio is highly achievable especially with the newly decided fiscal measures. But the ECB then EFSF/ESM will have to maintain an active SMP to avoid contagion through government refinancing rates.

Source: Pictet Asset Management

Eurozone: Key Messages

Recession in the Eurozone, no euro break-up but more fiscal federalism

- Eurozone contracted in 2011Q4. No collapse in 2012, the zone might even avoid a recession
- Germany is recovering, while Greece is entering into its 4th year of declining activity.
- Biggest risk remains a Greek downward spiral, notably in Spain: contracting activity – lower fiscal revenues – more fiscal austerity – additional contraction in activity
- Inflation to decline: no reason for the ECB not to continue loosening conventional & possibly unconventional monetary policy
- Euro debt crisis:
  - no euro break-up, but more fiscal integration
  - EFSF/ESM not a solution for Spanish/Italian financing needs, only the ECB can afford it (monetization… indirect QE)
  - ECB further non-conventional monetary policy to depend on two conditions:
    - a political commitment to fiscal federalism with credible fiscal rules (that will not be breached)
    - Complete disorderly market conditions
  - Greece, Portugal and Ireland to default … orderly

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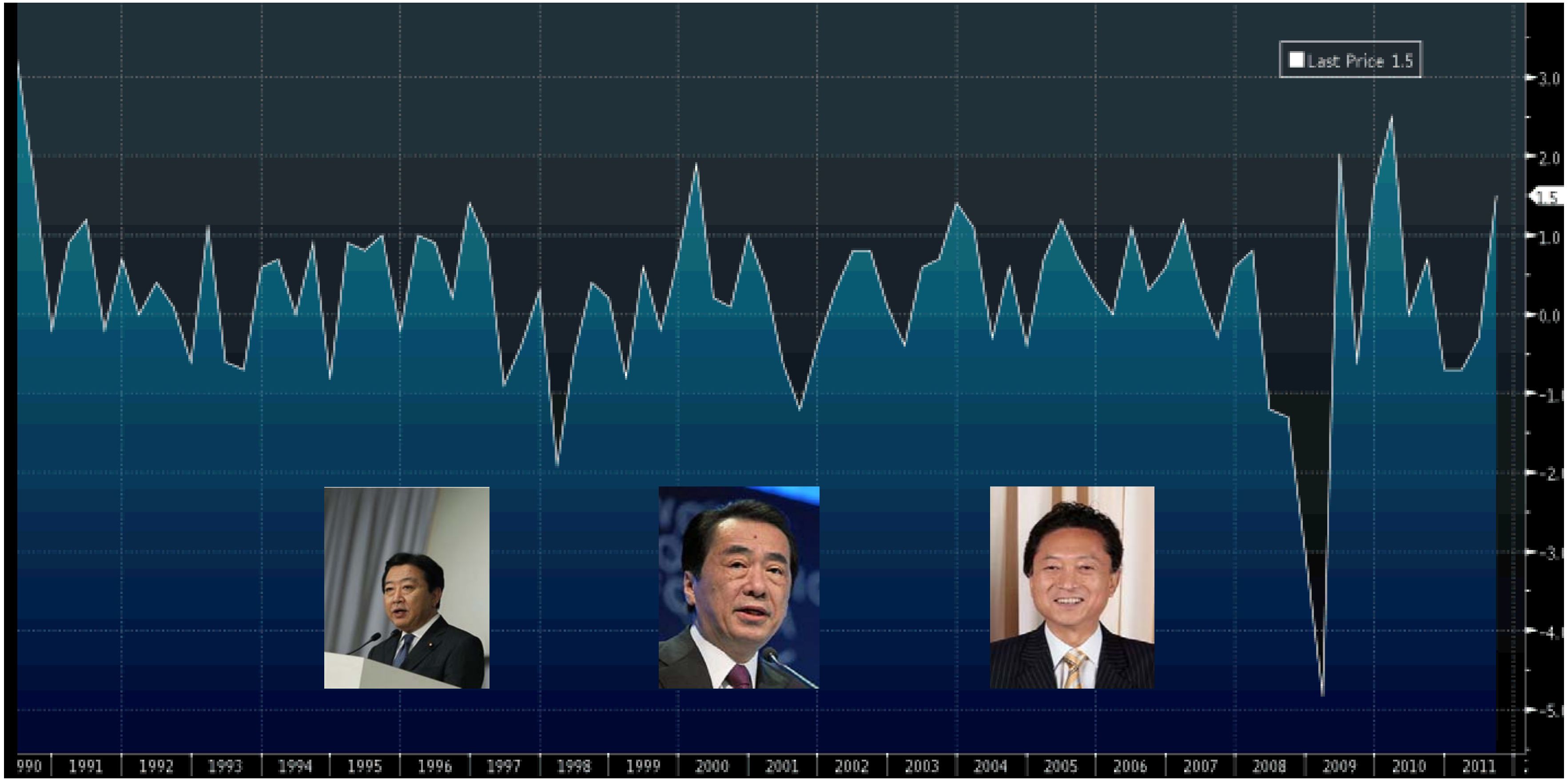
What should be done?

Wrong Way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Right Way?

What Should Be Done ?

- Surgery in Greece
- A wall – ECB – better than a firewall
- Control supranational (European) of the budgets of the euro area countries
- Lower interest rates in Europe
- Second phase: policies that promote growth consistent with the reduction of public expenditure

For more information, please contact your Pictet client relationship manager

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