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Euro Area: Despite Structural Improvements and Ongoing Support, Event Risks Remain

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Agenda

1. **Fundamental Progress**
2. **Role of Backstop Facilities**
3. **Fundamental Challenges**
4. **Conclusion: A Continued Muddle-through**

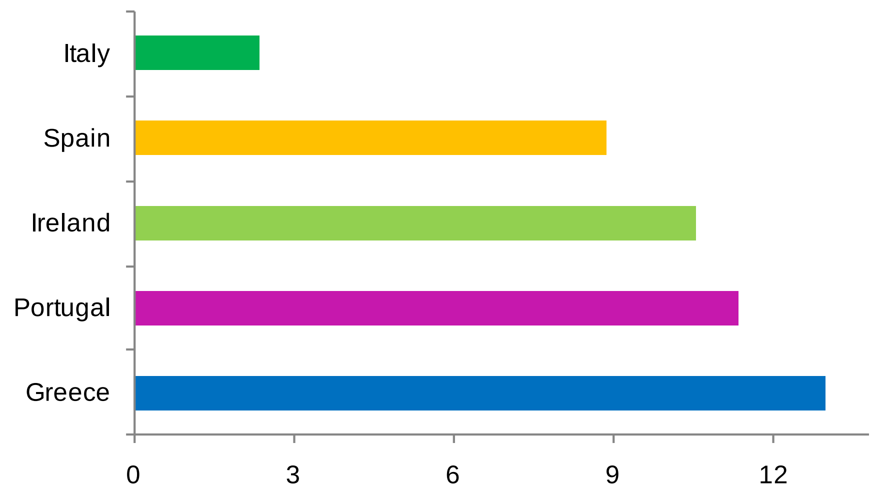
1

Fundamental Progress

More A Macro Than A Fiscal Crisis

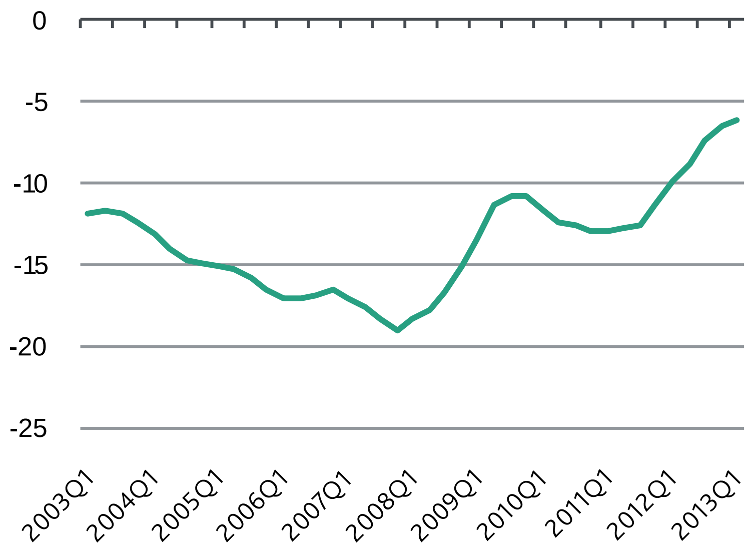
» **Strong current account adjustments with balances of periphery countries in or close to surplus**

2012-2008 Current Account Adjustment (% average 2008-2012 GDP)



Sources: Eurostat, Haver, Moody's

Periphery Countries Weighted Average Trade Balance with Germany (EUR Mn, 4Q ms)

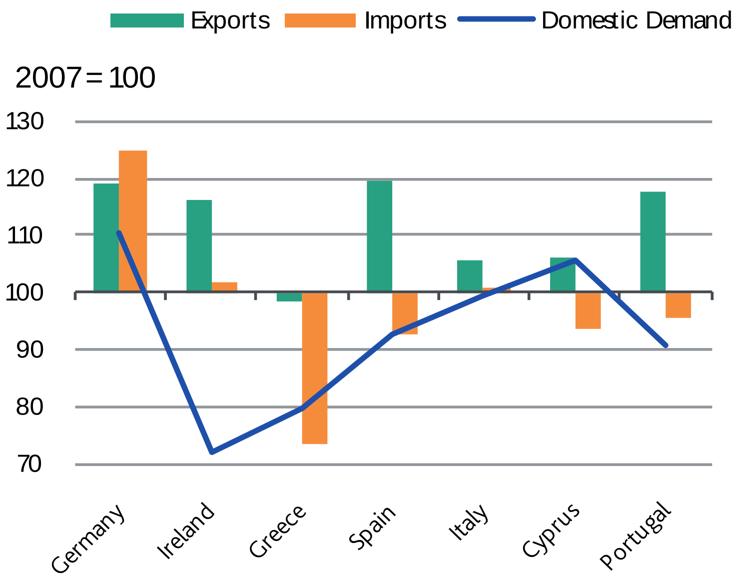


Sources: IMF, Haver, Moody's

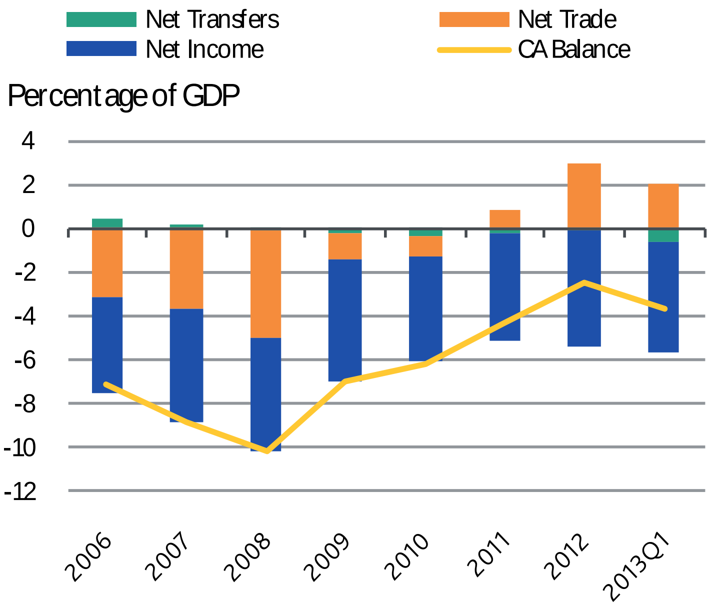
External Rebalancing Is Underway...

Significant Export Growth in Germany, Ireland, Spain and Portugal

Change in the value of Imports, Exports and Domestic Demand



CA Decomposition, EA Periphery

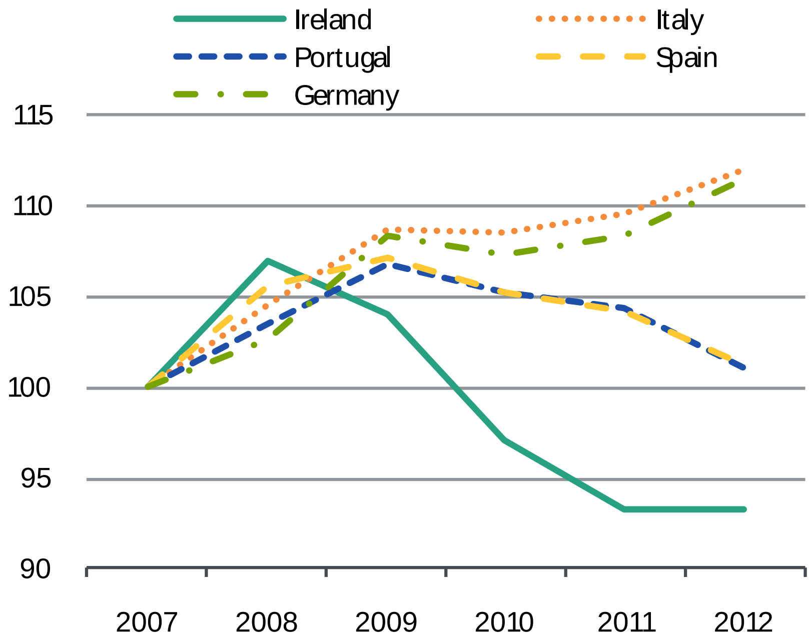


Sources: IMF, Eurostat, Moody's

…Driven By Improvements In Competitiveness

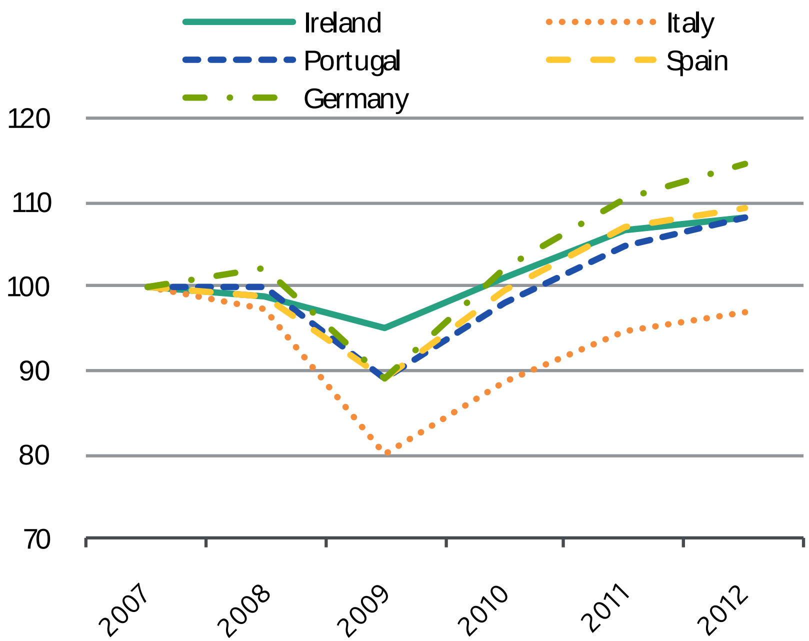
- Labor costs declining fast in periphery while increasing moderately in core
- Increase in real exports is main driver although collapse in real imports also plays a role

Nominal Unit Labour Cost Index (2007 =100)



Source: Haver – Eurostat, Moody's

Real Exports of Goods & Services Index (2007 = 100)



Source: Haver – Eurostat, Moody's

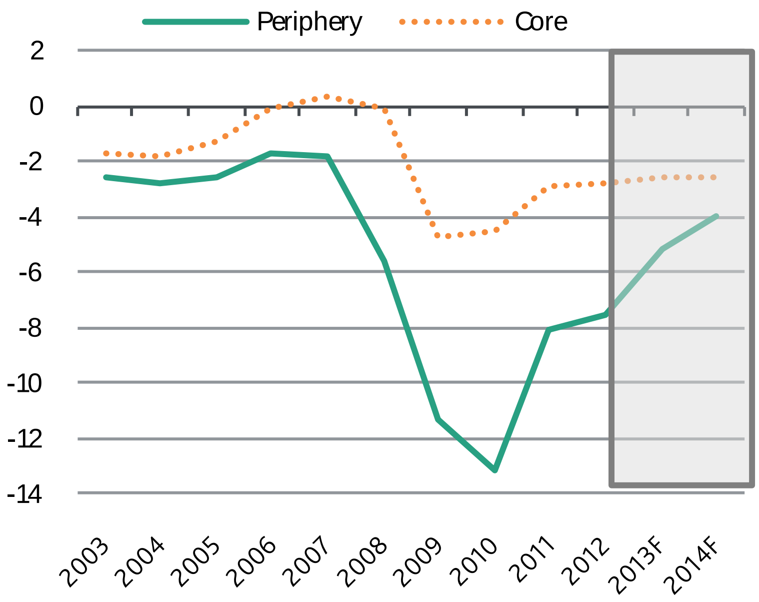
Fiscal Consolidation Is Progressing…

» More slowly than envisaged given weak growth environment in periphery

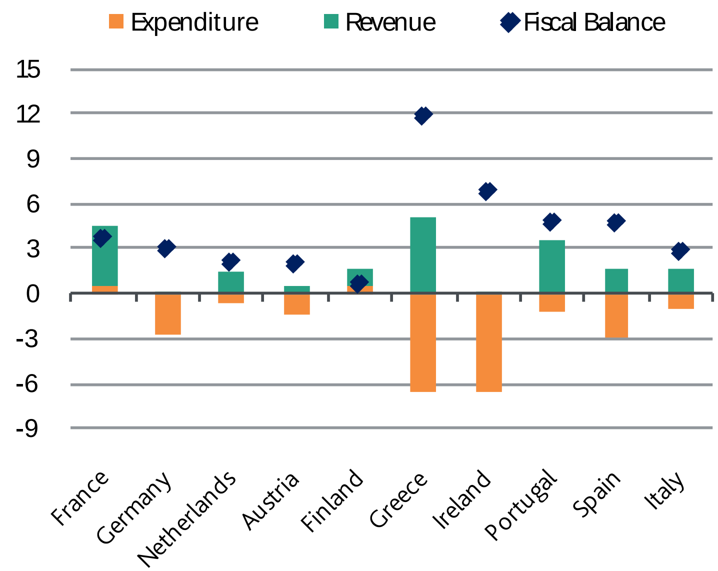
» Only limited adjustment in core countries to not dampen growth further

» Implementation of Treaty on "Stability, Coordination and Governance" aimed at strengthening governance of fiscal and macro-economic policy

Average General Government Fiscal Balance (% of GDP)



2013F-2009 Fiscal Balance Adjustment (% of GDP)

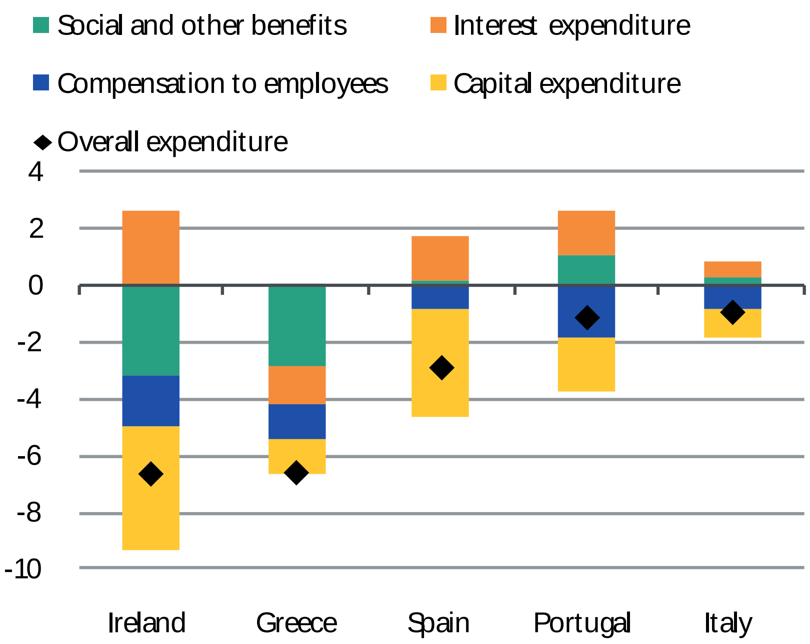


Sources: European Commission, Haver, Moody's

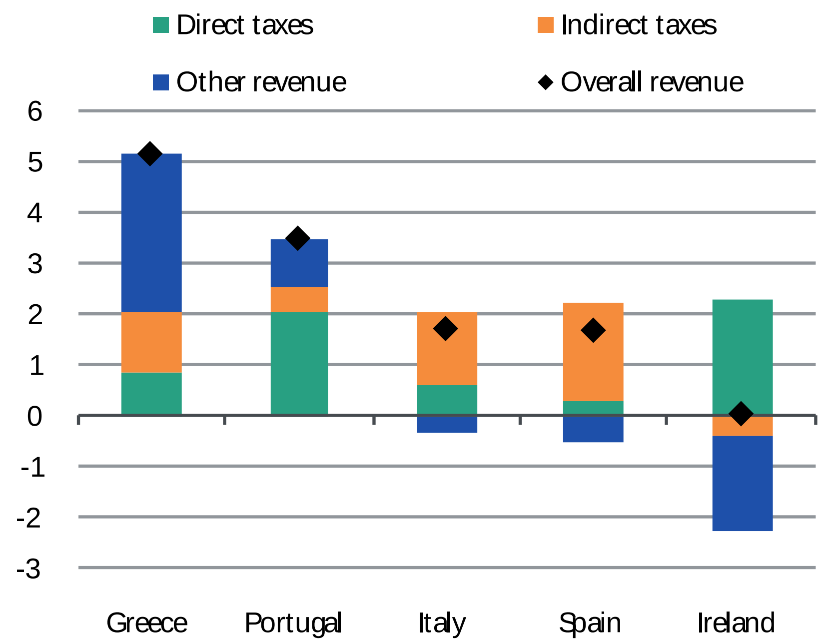
...Driven By Expenditure and Revenue Adjustments

» 5.4% of GDP average adjustment for Ireland, Portugal and Spain between 2009 and 2013F

2013F-2009 General Government Expenditure Adjustment (% of GDP)



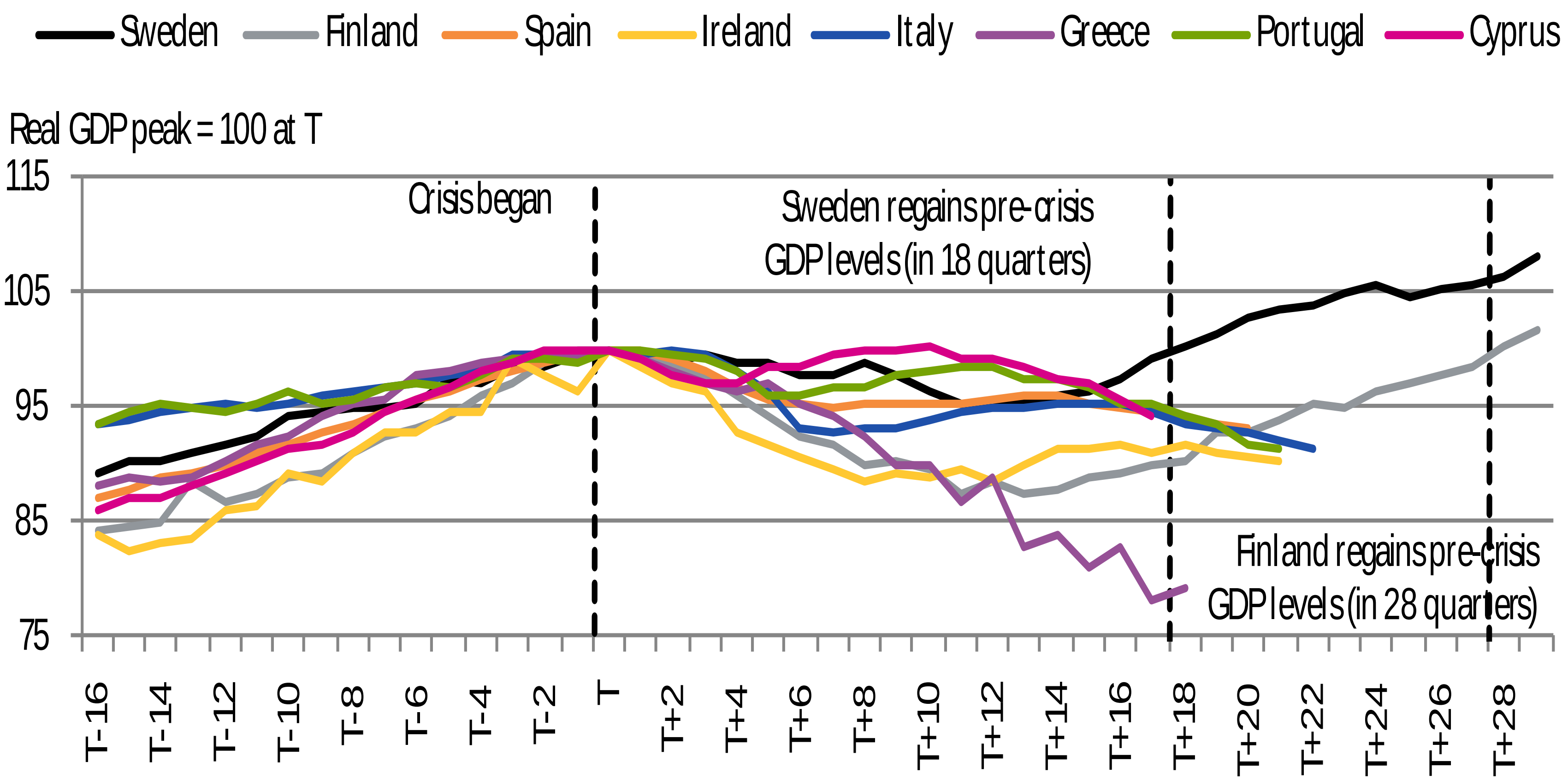
2013F-2009 General Government Revenue Adjustment (% of GDP)



Sources: European Commission, Haver, Moody's

Benchmarking the EA Debt Crisis

A Comparison to the Nordic Banking Crisis in the 1990s



2

Role of Backstop Facilities

From Fiscal to Monetary Backstops

Monetary Liquidity Programmes Complement Fiscal Backstop Facilities

Whereas the initial focus was on fiscal backstop facilities…

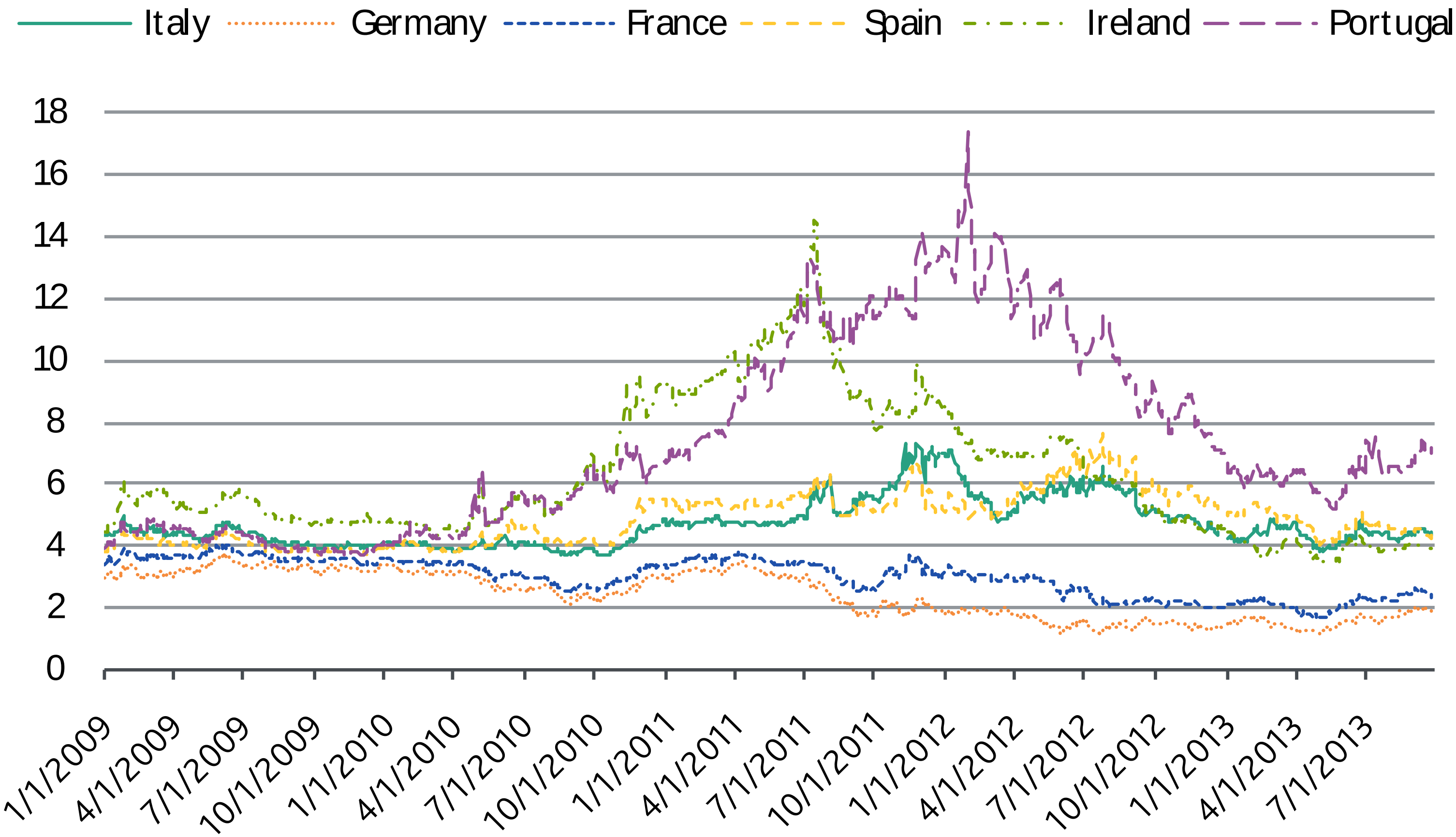
- » EFSF (June 2010-June 2013) - €250bn capacity remaining
- » ESM (Oct 2012-) - €500bn capacity, with ca. €40bn for Spanish banks
- » Before OMT, size was seen as an issue

…the relative market calm of the past year was induced by the ECB

- » ECB LTRO
- - Step change in policy by the ECB which bought time, though no game changer
- » ECB Outright Monetary Transactions
- - Reaffirmed ECB's willingness (and ability) to play supportive role
- - And succeeded in heading off a further shock – though limits as yet untested

EA Bond Markets More Resilient Now

Government Bond Yields Driven By Country Specifics and EA Situation



Sources: Reuters, Haver, Moody's

But There Are Shocks of Different Magnitude

» The increased flexibility of the ECB (OMT, LTRO) and the implementation of the ESM have brought relative market calm and mitigated liquidity concerns on euro area government bond markets.

» The apparent decrease in susceptibility to contagion has been reflected earlier this year with events in Cyprus and Portugal.

» That said, the need for a liquidity programme for a large country (Italy, Spain) or the exit of an euro area country (Greece, Cyprus) would be a shock that would likely test the shock-absorption capacity of these backstop facilities.

» While such a shock would almost certainly prompt a further policy response, the basic point remains that either of these two events (a large country bailout or an EA exit) would represent a systemic shock to the euro area.

An Aside: Progress On The Banking Union

Progress with Respect to the Banking Union Has Eventually Been Made

» Commission proposals for Single Supervisory Mechanism (SSM) agreed at ECOFIN in December 2012.

» ECB will authorise and supervise 130 largest banks initially – assets of €30bn, 20% of GDP or business in three countries – around 75% of total euro area bank assets. Ultimately supervise the rest.

» National authorities retain a role but ECB in charge. Precise split of responsibilities has still to be worked out. Deadline now March 2014.

» The Commission's proposal was to combine SSM with a single resolution mechanism (SRM) and financial support through ESM, a single deposit protection scheme, to centralise the cradle-to-grave process. Controversial (especially the common deposit scheme), full final scope unclear.

3 Fundamental Vulnerabilities

Fundamental Vulnerabilities

Significant fundamental concerns remain, including:

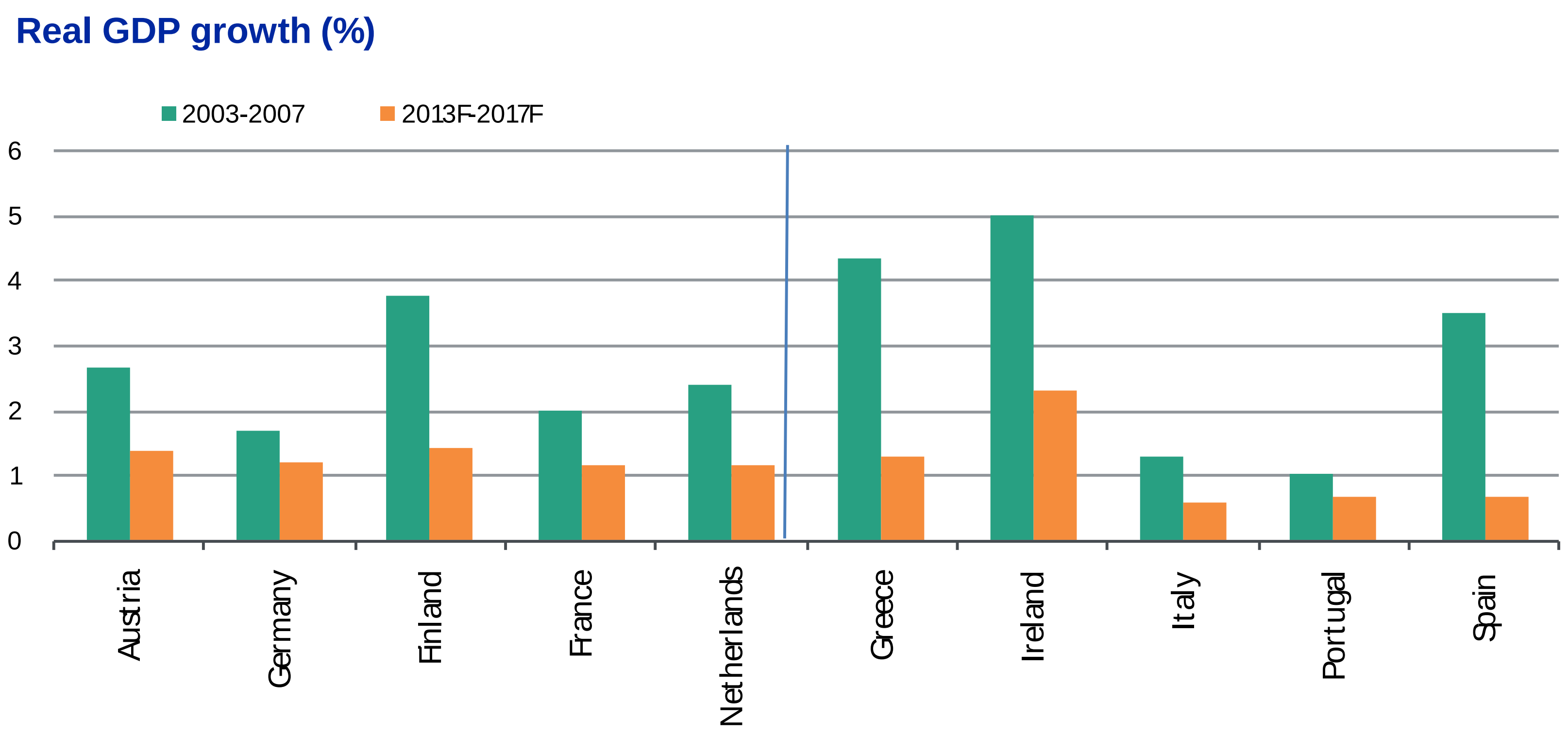
(i) Subdued growth outlook in peripheral countries;

(ii) Rising general government debt levels;

(iii) Slow progress on a full-fledged banking union;

(iv) Country-specific developments that point to elevated political event risk.

Low Growth Poses Implementation Risks

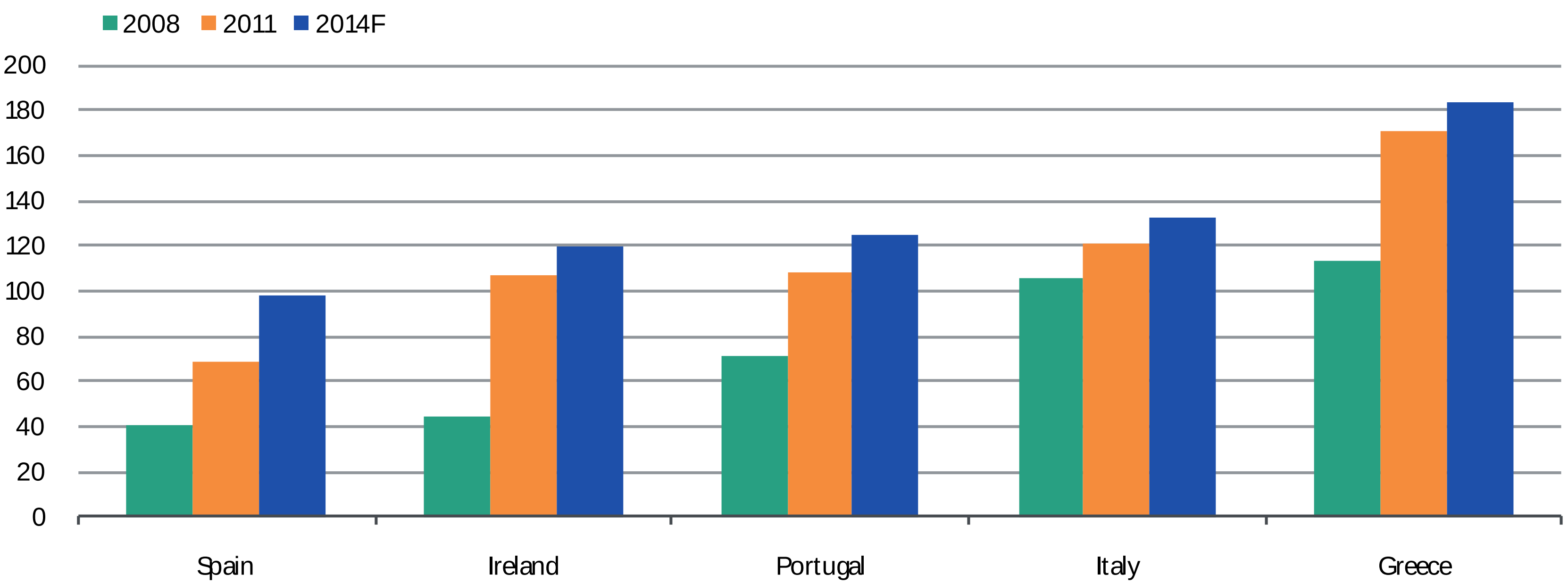


Sources: IMF, Moody's

Government Debt Ratios Are Still Rising…

- GG debt to peak for most peripheral countries only in middle of the decade
- Another 20 years of fiscal adjustment needed to return to debt level of 60% of GDP

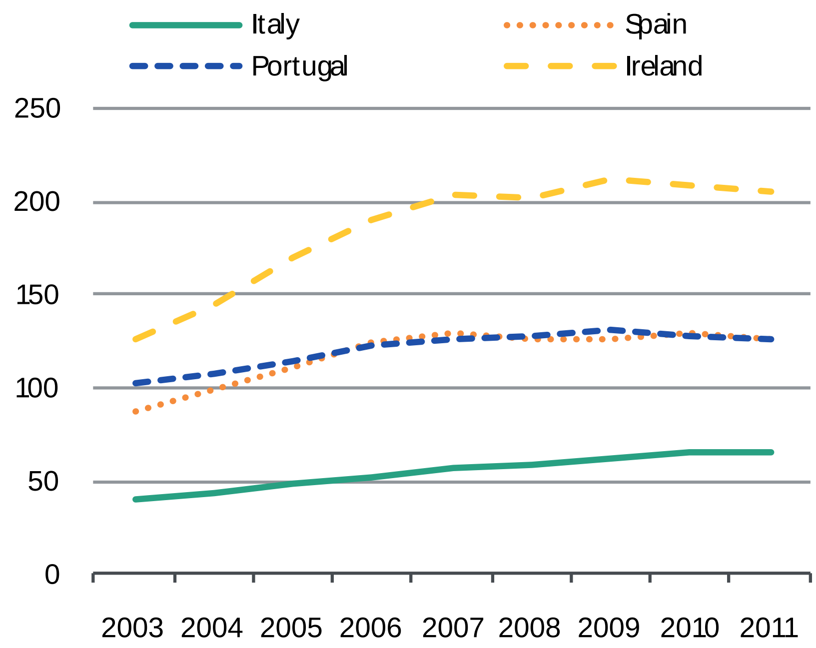
General Government Debt (% of GDP)



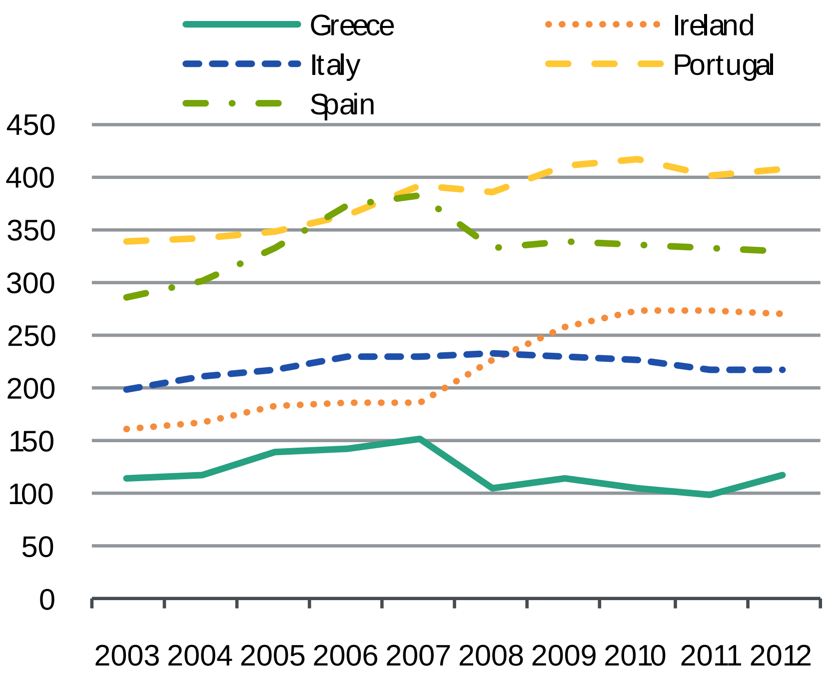
Sources: Eurostat, Haver, Moody's

...Deleveraging In Private Sector Only Beginning…

Households Gross Debt (% Households disposable income)



Non-Financial Corporations Financial Liabilities (% of GDP)



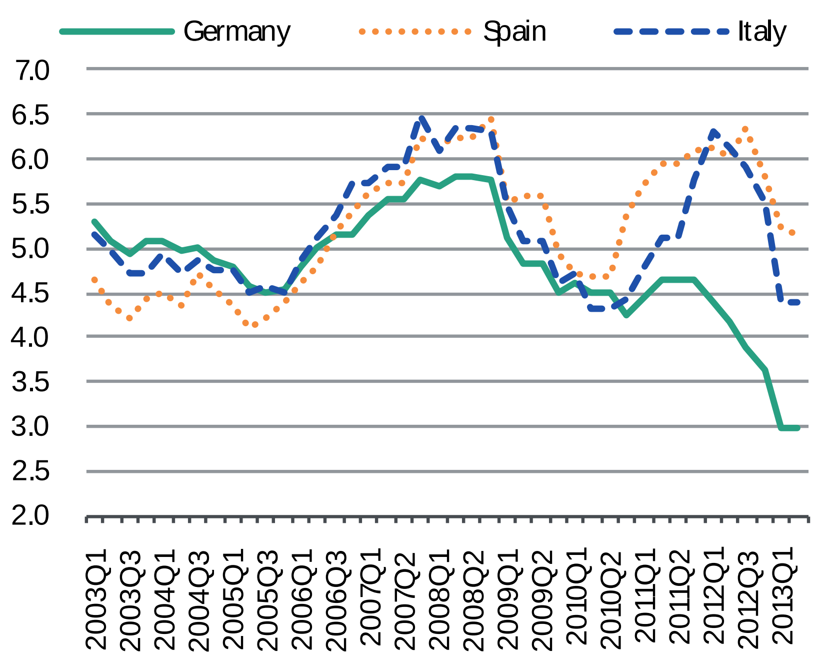
Sources: Eurostat, Haver, Moody's

…And Fragmentation of Banking Systems Is Not Resolved

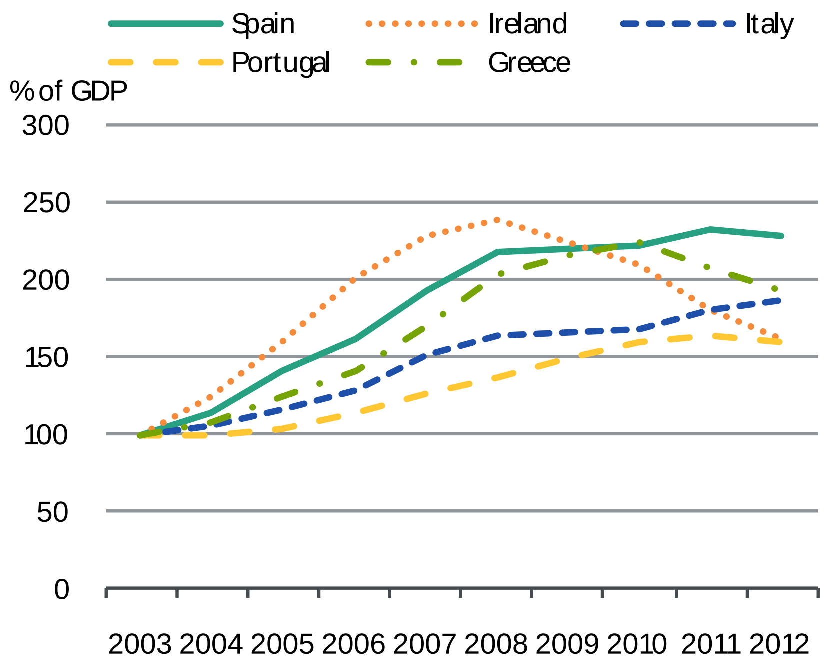
» OMT and Banking Union proposal to break "vicious cycle" between sovereigns and banks

» Bank deleveraging to constraint economic growth

Average Lending Rates to Businesses (%)



Banking System Assets Index (2003 = 100)



Source: ECB, Haver, Moody's

Political Risks Remain Substantial

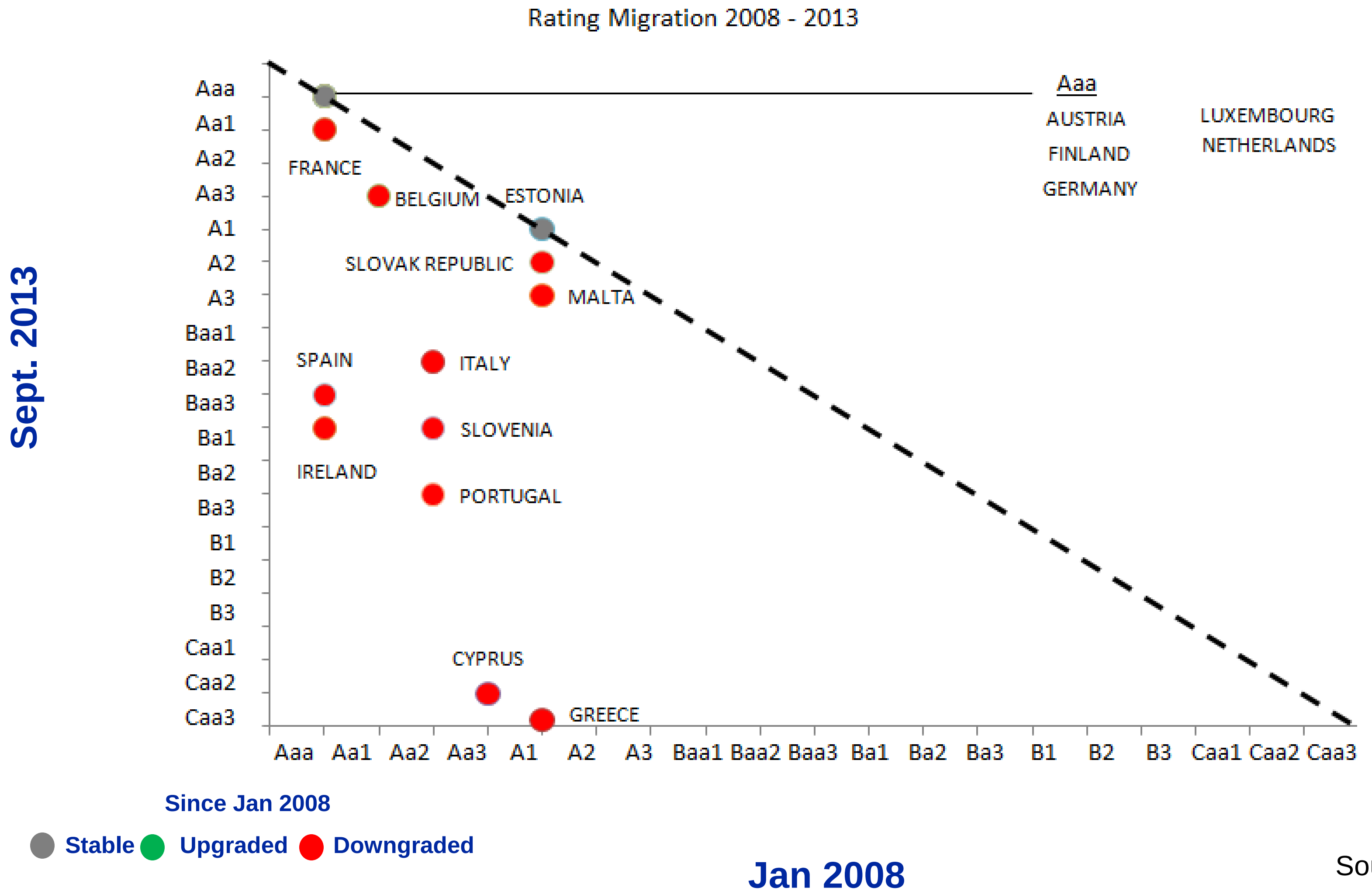
- Cyprus (Caa3, NEG)
  - Damage to banking sector has been done, and not only in Cyprus
- Implementation risks to fiscal and banking union
  - Tensions still present between national & euro area agendas and preservation of sovereignty
  - Timing/scope of banking union uncertain
  - Reduced market pressure to pursue reform
- Risk of slowing fiscal and structural adjustment in periphery amid improved market sentiment and social fatigue
- Electoral cycle – ongoing political instability in Italy; new coalition in Germany?
- Event risks, in particular increased political risks, in Greece remain elevated

4

Conclusion: A Continued Muddle-through

Sovereign Ratings Since January 2008

2008/2013 Rating Constellation



Source: Moody's

Recap: The 2012/2013 EA Environment

- Negative rating actions last year were driven to an important extent by the view that the euro area debt crisis negatively affects all the euro area member countries.
- Periphery countries were negatively affected because their economic and fiscal weaknesses exposed them to the risk of a severe funding shocks.
- Core countries because of the significant contingent liabilities that they were assuming.
- Stable outlooks remained only for countries that had exceptionally resilient government balance sheets – Finland and Estonia.

The State of the Euro Area…

The euro area environment is characterized by:

i. Resumption of economic growth, although subdued for the foreseeable future;

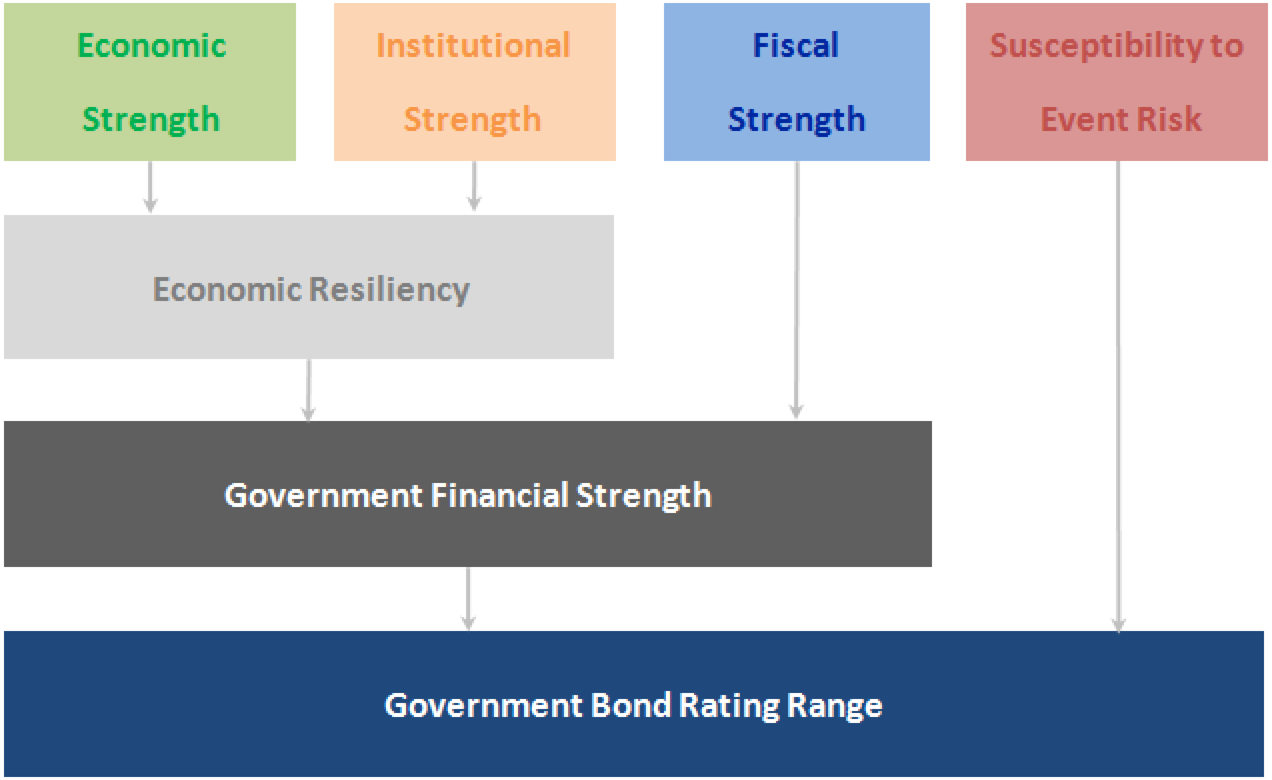
ii. Relative market calm coexisting with significant contagion risk;

iii. Sizeable contingent liabilities that link credit risks across countries;

iv. In some countries significantly pressured banking systems.

…In Light of the Sovereign Bond Rating Methodology

How the Factors Combine to Determine a Rating Range



Outlook: 2013/2014 Perspectives for Non-Core Countries

Countries differ in their ability to adjust to the challenging euro area environment. Their situation reflects a combination of the following factors:

i. Fundamental progress in the respective countries;

ii. Growing market access and/or a liquidity situation, albeit partially reflecting the availability of ESM/OMT support as a backstop that effectively mitigates contagion risk;

iii. Stabilizing and affordable debt levels including contingent liabilities;

iv. A stabilization of the respective banking systems to the extent that no further crystallization of significant CLs on the government balance sheet is expected.

In this context, we recently changed the outlooks on Ireland (Ba1), Malta (A3) and Slovakia (A2) to stable from negative.

Outlook: 2013/2014 Perspectives for Core Countries

» Core countries' situation would stabilize in a scenario in which the situation at the euro area level were to improve (in terms of economic growth, debt levels and further institutional progress).

» In particular if the contingent liabilities related to Italy and Spain were diminishing, and the risks of an exit of Greece and Cyprus were decreasing.

» However, in some countries country-specific negative developments may offset positive developments at the euro area level.

Related Research

- EU Bank Resolution: Draft Directive Offers Clarity On Future Support Framework, But Important Questions Remain Unanswered, September 2013
- Update on Structural Reforms in the Euro Area Periphery, August 2013
- Sovereign Bond Ratings, September 2013
- Refinements to the Sovereign Bond Rating Methodology, September 2013
- Sovereign Default and Recovery Rates, 1983-2012, June 2013
- Moody's Default Definition and its Application to Sovereign Debt, April 2013
- Local Currency Country Risk Ceiling for Bonds and Other Local Currency Obligations, March 2013
- Proposed Refinements to the Sovereign Bond Rating Methodology, December 2012

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