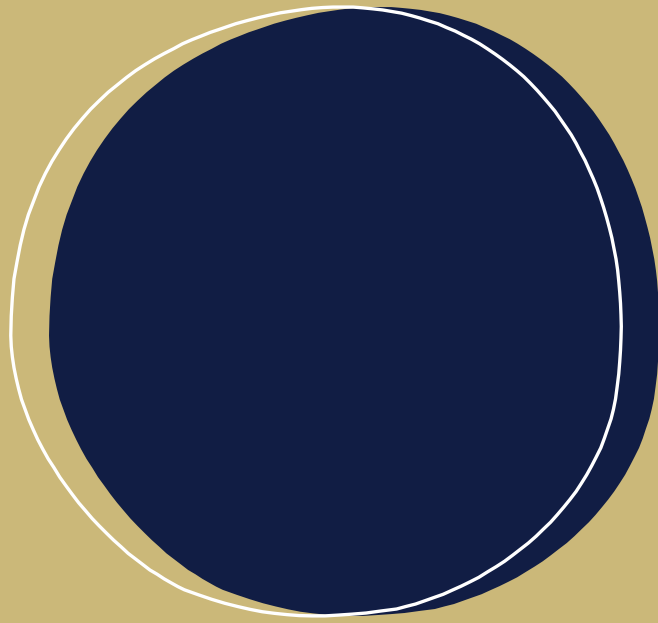


News from the financial markets

ECB puts pressure on weak member states

November 23, 2009





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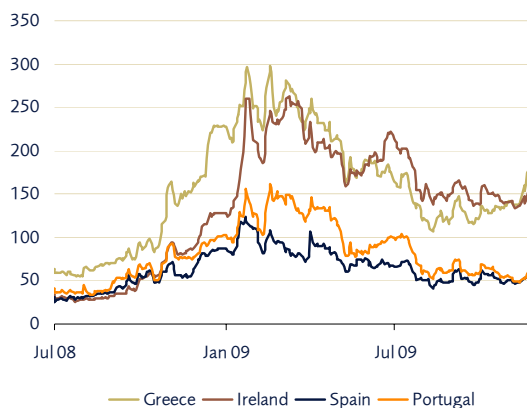
Dr. Jörg Zeuner, Chief Economist

The yield on Greek sovereign debt has skyrocketed in recent weeks. The nation's budget situation has to be cleaned up as soon as possible – a move that presumably will be forced by rising risk premiums in the capital market. The ECB is making things more difficult for the most highly indebted EU member states.

Greece is the first to come under pressure

The new Greek government shocked the markets by forecasting a deficit for 2009 that is likely to come in at 12% of GDP – almost twice the IMF estimate indicated in August. This is all the more startling given the fact that the recession in Greece is turning out to be relatively mild compared to the rest of Europe. In view of interest payments that account for roughly 10% of total national outlays, a considerably higher share of discretionary spending on the part of the Greek government, and indebtedness that runs at more than 110% of GDP, a budget consolidation is urgently needed. As soon as interest rates start to rise again, such an undertaking will become unavoidable.

Yield differential, 10-year government bonds vs. Bunds

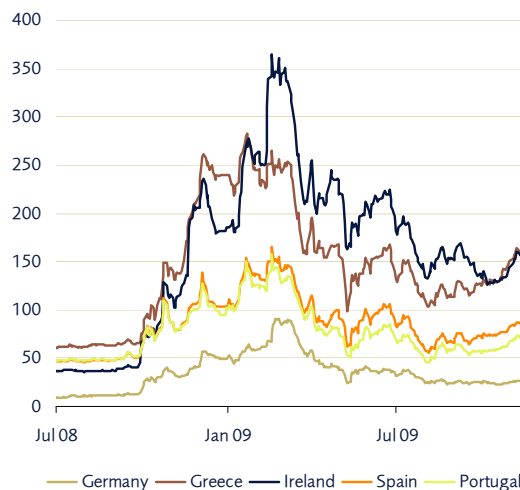


Sources: VP Bank, Datastream

Already before the onset of the crisis, the European Commission called for Greece to realize savings of more than one percent of GDP per year. Since then, the country's deficit has doubled. We anticipate that Brussels will impose much more stringent requirements on Greece – with a negative impact on domestic growth being the result.

The European Commission's recommendations lack bite. Too many states have ignored the Commission in the past. However, we are going on the assumption that market forces will spur either a consolidation on the part of the Greek government or financial assistance from the other EU member states. The premiums on hedges against a potential default (CDS spreads) are on the rise. And for a number of financially distressed countries, the government bond yield differential versus German Bunds has also skyrocketed of late (even as it has narrowed for the fiscally solid member states).

CDS spreads on 10-year government bonds



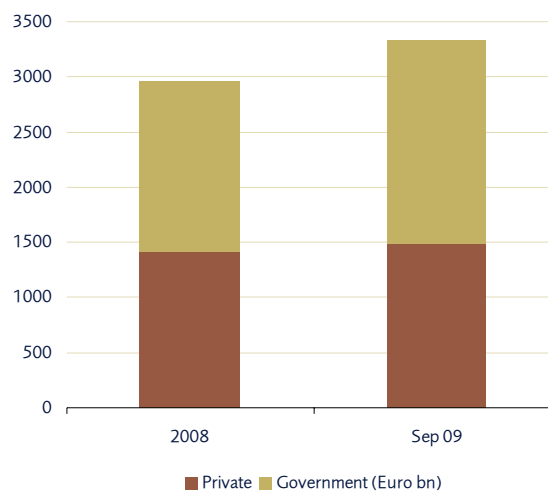
Sources: VP Bank, Datastream

The ECB is increasing the pressure

The ECB's gradual tightening of monetary policy is slowly shedding light on the weaknesses of several national budgets. Over the weekend, the central bank announced that it is again raising the quality requirements for bonds that can be used for margining purposes. Soon, all new issues of asset-backed securities (ABSs) will be required to have a rating of at least AAA/Aaa from a minimum of two recognized rating agencies in order to be "allowable". Regulations such as these will make it more difficult next year for commercial banks to refinance their operations at favorable conditions.

The financing leeway for EU member states can also be expected to shrink as a result of the commercial banks' limited refinancing opportunities. This past year, the banks have been an important source of funding for euro zone governments. The volumes of other issuers included in the EU's consolidated banking balance sheet have hardly increased. Going forward, this approach to deficit financing will become more difficult, thus the states will have to resort increasingly to non-banks in order to place their bonds. That in turn will propel yields higher.

Bonds held at euro zone banks: government versus private



Sources: VP Bank, Datastream

The bottom line:

The economic policy debate is shifting its focus increasingly in the direction of fiscal policy for the coming years. We expect to see an increase in risk premiums on the sovereign debt of financially weak EU member states, with Greece leading the pack.

Bond investors who do not wish to hold these bonds until maturity are well advised to reduce their exposure to the peripheral EU states in order to avoid potential book losses. Others who are waiting for their bonds to mature can feel free to keep their positions. We still consider the probability of any default to be negligible.

The VP Bank Group

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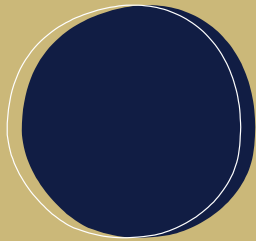
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