GERMANY TAKES THE STRAIN

Throughout the Eurozone sovereign crisis Germany has been the region's only consistent sovereign safe haven. However, the consequences of anchoring Europe's economy – including the impact on Germany's banking system and contingent liabilities from event risk – cannot be ignored. Experts in Europe describe how different scenarios of the Eurozone debt crisis might affect Germany's funding future.

BY SONIA HAN

"I'm tired of the eternal 'if and when': We're short of money, well fine, so fetch some then."

– **THE EMPEROR** *FAUST: THE SECOND PART OF THE TRAGEDY*, JOHANN WOLFGANG VON GOETHE, 1832

In Goethe's play, Mephistopheles – an apparent fool who is in fact an agent of the devil – saves the imperial finances of the Holy Roman Emperor by introducing the use of paper money instead of gold to encourage spending and boost the economy.

Nearly two centuries later, the US has seen two rounds of quantitative easing from the Federal Reserve, from 2008 to 2011, with a third announced in September 2012. Meanwhile, hardliners in Europe – represented by Jens Weidmann, the Bundesbank president – have argued that outright quantitative easing can only be carried out if the central bank controls the currency used.

With the European Central Bank (ECB) unable to unilaterally expand euro money supply, outright monetary transactions (OMT) was announced as the distribution mechanism of the European Stability Mechanism (ESM) on September 6 2012.

OMT, under which the ECB is permitted to conduct secondary market purchases of Eurozone sovereign bonds following a governmental request for assistance, is both a bailout mechanism and a *de facto* quantitative easing tool. Both of these, especially in the context of Germany's historical fear of the inflationary impact of loose money supply control, remain controversial.

"Germany, the US, the UK and France are all triple-A rated countries with a negative outlook. There are some risks but they all have top-notch ratings and in my view that has to be acknowledged when looking at Germany – the government and also the economy."

DIETMAR HORNUNG MOODY'S INVESTORS SERVICE

"Central banks are traditionally the lenders of last resort to banks, but should they be the lenders of last resort to government?" asks Stefan Schneider, chief international economist and head of macro trends at Deutsche Bank in Frankfurt.

According to article 123 of the Treaty on the Functioning of the European Union (EU), the ECB and national central banks are prevented from directly purchasing debt obligations from member states. "This is the ultimate limit. Then you ask to what extent there is room for manoeuvre. If the market has doubt about the euro's long-term sustainability or whether a particular country will stay in the Eurozone forever, it is up to the politicians to squash it out by policy measures. It can't be a job for central banks," adds Schneider.

However, Mario Draghi, president of the ECB, was resolute in his testimony in early September: article 123 prohibits the purchase of sovereign bonds in the primary market but to buy in the secondary market in unlimited quantities does not violate the rule. The need for urgent and wide-scale action to finally put a floor under the Eurozone crisis appears to have been recognised by the German Federal Constitutional Court's acceptance of the legality of the ESM package (see box on p24).

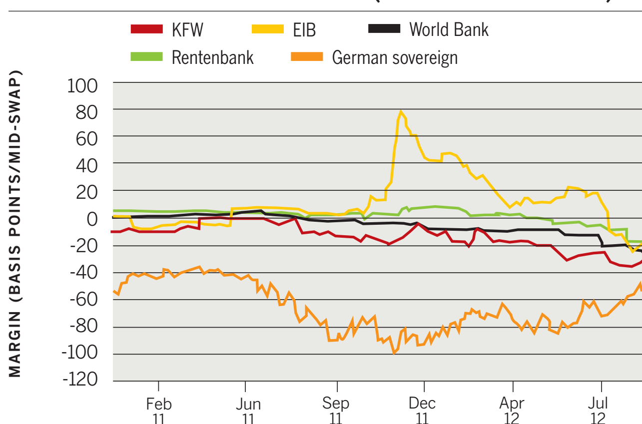
PRESSURE POINTS

With the ESM on its way, Europe appears to be moving towards a positive solution. And even in the depths of the crisis-driven volatility in the second half of 2011, German sovereign and quasi-sovereign bond spreads suggest they remained a safe haven for investors – in the euro market, at least (see charts on this page).

However, the ongoing volatility has made for continual challenging conditions for German borrowers (see box on p26). "Headline risk has increased for all markets due to the European debt crisis and the right timing for a transaction has become much more important for issuers like KfW Bankengruppe [KfW] – not only in the Kangaroo market," Klaus-Peter Eitel, Frankfurt based vice president, capital markets at the German agency, tells *KangaNews*.

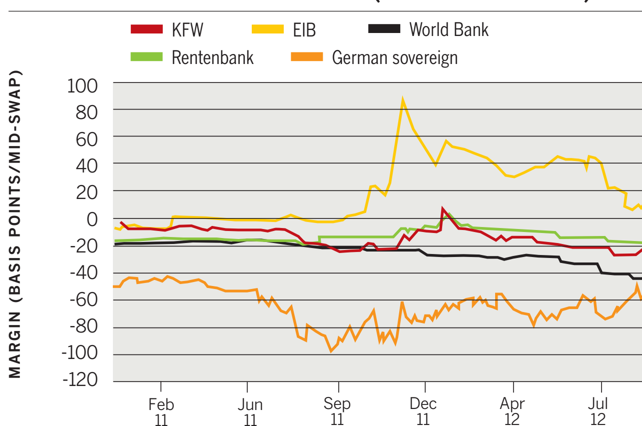
Nonetheless, there is a degree of optimism in some quarters that the latest effort to anchor the crisis will advance the cause of Eurozone stability. "Obviously we have the liquidity concern in Europe and it is reassuring that the ECB, with the announcement of OMT, seems willing to play a more flexible role. That mitigates the concern to some extent," says

EUR BOND SPREAD PERFORMANCE (FIVE-YEAR MATURITY)



SOURCE: DEUTSCHE BANK SEPTEMBER 4 2012

EUR BOND SPREAD PERFORMANCE (10-YEAR MATURITY)



SOURCE: DEUTSCHE BANK SEPTEMBER 4 2012

Dietmar Hornung, Frankfurt-based vice president and senior credit officer at Moody's Investors Service (Moody's).

While the mechanism just might be in place, the scale of the task is immense. And there is one country in the hot seat: Goethe's homeland, Germany. On July 23 Moody's revised the outlook on its Aaa sovereign ratings of Germany to negative from stable, based on the uncertainty of the euro area outlook, the potential impact of event risk, and the German banking system's vulnerability stemming from its exposure to Italy and Spain in particular.

"Germany has favourable fundamentals: the deficit is very low and the economy has been growing fast. Obviously, it has slowed now with the Eurozone tension, but it still has medium-term growth potential. Interest rates are also low and the country has all the ingredients of a declining debt path."

GERGELY KISS FITCH RATINGS

GERMANY'S ESM APPROVAL SURVIVES COURTING PERIOD

Germany was the last country in the Eurozone to ratify the European Stability Mechanism (ESM), as a consequence of pressure from split internal opinions. On September 12 the German Federal Constitutional Court in Karlsruhe dismissed legal challenges and gave the green light to the permanent euro area rescue fund.

The ESM is expected to have total subscribed capital of €700 billion (US$909.6 billion), of which €80 billion will be paid-in capital, and to have a real lending capacity of €500 billion. Germany, with the largest GDP in the Eurozone, will contribute the biggest share – 27.15 per cent or €190 billion – followed by 20.39 per cent from France and 17.91 per cent from Italy. The ESM is due to replace the temporary European Financial Stability Facility (EFSF), which expires on July 1 2013.

Ulrich Kater, DekaBank's chief economist, sees these bailout funds as a step towards a solution. "The EFSF and, afterwards, the ESM are necessary to reduce uncertainty in Europe. This will have a positive and stabilising effect on the German economy which highly depends on exports to Eurozone countries," he says.

The new system is more efficient than the EFSF, according to Gergely Kiss, sovereign group analyst at Fitch Ratings. Kiss points out that when a country wants to borrow from the EFSF, the cross debt of other member countries increases by more than the amount borrowed, through guarantee. But he adds: "Under ESM, countries pay in capital and will be able to raise sums with a guarantee of much less than the amount lent."

Under the current regime, Germany is engaged with at most €211 billion out of the €700 billion to the EFSF, though that upper limit is to some extent nominal. "A problem arises if other European countries fail to guarantee their part of the EFSF. In this case it may be that Germany's part has to be increased, though there exists an upper limit of about €250 billion," explains Kater.

The Constitutional Court demanded a guarantee that none of the ambiguous regulations of the ESM treaty can be used to increase Germany's maximum liabilities beyond €190 billion without parliamentary approval.

Legal approval to push on with the ESM does not mean the end of internal pressure in Germany. Market polls, such as one conducted by *Financial Times/Harris* in August, show that more than half of Germans think Greece should leave the Eurozone, while German mainstream political parties are committed to keeping the Eurozone together.

Germany's chancellor, Angela Merkel, is at the centre of the heat. As a supporter of the ESM, the Constitutional Court ruling might just turn out to be a costly political win for her. "She is in a pretty awkward position. On one hand, She needs to make sure she doesn't come across as wasting German's taxpayers' money. On the other, she doesn't want to be the person whose name goes down in history books as being responsible for pulling the plug on the Eurozone," says Stefan Schneider, chief international economist and head of macro trends at Deutsche Bank. "The Eurozone crisis is intensifying in the short term and it might ruin Merkel's chances of getting elected again in 2013."

However, Schneider also points out that the detail of the ESM needs to be carefully watched. "It is not clear whether the court's reservations can be dealt with unilaterally, via a protocol linked to Germany's ratification, or whether it requires reformulation of the treaty itself. In its preliminary verdict the court mentioned that it might discuss to what extent the ECB could be overstretching its mandate with the overnight money transactions (OMT) initiative announced on September 6. This should ensure that Karlsruhe will remain on the market's radar screens."

"IN ITS PRELIMINARY VERDICT THE COURT MENTIONED THAT IT MIGHT DISCUSS TO WHAT EXTENT THE ECB COULD BE OVERSTRETCHING ITS MANDATE WITH OMT. THIS SHOULD ENSURE THAT KARLSRUHE WILL REMAIN ON THE MARKET'S RADAR SCREENS."

STEFAN SCHNEIDER DEUTSCHE BANK

Hornung explains: "We have entered a new phase of the euro area debt crisis. In the first phase, relatively small countries and their banks were under stress. Now there is stress on Italy and Spain. That changes the nature of the crisis. As the fiscal anchor of the euro area, a deterioration of the area has repercussions on Germany."

According to Hornung, if Italy and Spain get into stress there will be a significant increase in contingent liabilities of core euro countries. The fact that Moody's no longer felt comfortable that Germany could insulate itself from the Eurozone debt crisis to the extent that a triple-A, stable rating would be justifiable was one of the main drivers of the rating agency's decision to assign a negative outlook.

This view is not universal, though. In the days after the Moody's rating action, Fitch Ratings (Fitch) and Standard & Poor's (S&P) both affirmed Germany's AAA stable outlook. In its ratings report, S&P showed confidence in the country's economic resilience, saying it was demonstrated when Germany absorbed the large financial shocks in the reunification of West and East Germany in the 1990s and the global recession in 2009.

However, Europe and Germany are clearly facing a much deeper problem now than they did three years ago. "In 2009

countries were able to rescue banks, which were the main source of risk and uncertainty. Today, countries are a source of uncertainty too. Most European countries have only very little leeway to deal with the current economic and fiscal problems – the level of public debt does not allow any further programmes to strengthen the economy," says Ulrich Kater, chief economist at DekaBank in Frankfurt.

BANK CONDUIT

Germany itself has been forced to use some of its bullets in recent years. In 2008 the country had to rescue some of its own banks through the establishment of the Special Financial Market Stabilisation Fund (SoFFin), a €480 billion (US$623.7 billion) programme for recapitalisation and the purchase of bank assets. "The public sector spent a large amount of money on Hypo Real Estate and WestLB. Germany's debt-to-GDP ratio has increased quite significantly through the backdrop of this engagement," says Hornung.

SoFFin stopped providing new facilities in 2011 but continues to offer a guarantee. And Deutsche Bank's Schneider says the German banking system is not out of the woods: "Under a more extreme scenario, if consumers freaked out in the Eurozone, banks would have a problem and ultimately the government would have to step in to save the banking system,"

Although it affirmed Germany's outlook, Fitch agrees that the German banking sector is on a tough road. "German banks were expanding fast into other markets in the Eurozone. But now they are withdrawing funds from other member states to focus on the domestic market, where it's a very competitive environment with lower profit margins," says Gergely Kiss, sovereign group analyst at Fitch in London.

"We have a low interest rate environment plus a flat yield curve and there are low client activities in asset management and investment banking. The earnings outlook and capital generation capacity of the German banking sector are poor," adds Hornung.

On top of this, calculating the exposure to peripheral countries is not a rosy job for the economists. According to Kater, the German banking sector's total exposure to other European countries amounts to over €1 trillion, with €308 billion being to southern European countries.

"The exposure to Spain has been brought down to €140 billion from €180 billion at the end of 2010 and, for Italy, to €130 billion from €160 billion. The exposure is still very high despite the banks' caution," adds Deutsche Bank's Schneider. "Italy has historically weak growth and a high debt-to-GDP level of around 120 per cent. If there is even a minimal increase in its funding cost, the country will end up in a debt spiral."

Kater believes the German government would be forced to provide further support to the banking system if either one or more countries left the Eurozone or the Eurozone itself collapsed – with a serious impact on the national economy in either case. In both situations the questions to be solved would be what part of credit is written off and in which currency debts are paid back.

SOVEREIGN SOLIDITY

Despite all this, Germany is still a premium sovereign – even according to Moody's. "Germany, the US, the UK and France are all Aaa-rated countries with a negative outlook. There are some risks but they all have top-notch ratings and in my view that has to be acknowledged when looking at Germany – the government and also the economy," says Hornung.

Markets did not panic following the Moody's move in July. "Stock market prices already reflected risks from the euro crisis. This is supported by the German DAX Index which recovered within a few days after the revision," confirms Kater. He adds: "The impact on German government bonds was very small as well. Yields are at very low levels – even zero or negative for maturities up to two years. It seems that most investors are aware of the risks and that the revision of the ratings was already reflected in market prices."

Sovereign risk indices provide a clear picture of where German credit risk stands. The BlackRock Sovereign Risk Index summarises debt sustainability based on relevant fiscal, financial and institutional metrics. Indicators – including fiscal space, external finance position, the willingness to pay, and financial sector health – are used to gauge the creditworthiness of countries. As of the end of June 2012, Germany is still one of the most resilient economies in the world, ranking seventh out of the 44 countries in the index – one position ahead of Australia (see chart on p29).

"At the moment Germany has favourable fundamentals: the deficit is very low and the economy has been growing fast. Obviously, it has slowed now with the Eurozone tension, but it

>>CONTINUED ON P28

"The main question is whether European governments can prevent contagion effects to other countries. It will be avoided because European governments will convince markets that the Eurozone stands together. The worst-case scenario is a breakup of the Eurozone with a long-lasting and deep recession. But the probability for this event is very low."

ULRICH KATER DEKABANK

MARGINAL IMPACT: AUSTRALIAN DOLLAR BORROWING AND THE EUROZONE CRISIS

Eurozone borrowers, even sub-sovereign names from the German safe haven, have been punished by investors around the world. While the spread impact in Australia has at times been accentuated, market participants are reluctant to claim Australian dollar investors are always out of synch with their peers.

In Australia, spreads on major Kangaroo borrowers like KfW Bankengruppe (KfW) and, especially, European Investment Bank (EIB) blew out significantly from late 2011 (see chart on facing page).

"In times of high headline risk the volatility in the Australian market has been much higher than in other markets," says Klaus-Peter Eitel, vice president, capital markets at KfW. "While we feel that investors in Australia are very well informed, we attribute this increased volatility to the time difference from Europe."

Australia's geographical remoteness from Europe poses a challenge for investors. "The timing of some of the sharper spread movements we have seen over the past 12-24 months has often lagged in the Australian market so that Kangaroo spreads would often mirror the same themes as core markets, such as USD and EUR, with a delay," explains Alex Caridia, head of SSA origination, Europe at RBC Capital Markets,

"I don't think Australian investors took a different view from investors elsewhere in the globe," confirms Guy Reid, London-based originator at UBS Investment Bank. "In the euro and US dollar markets, investors can express their view on Europe through a variety of names including peripheral sovereigns. There are limited options for investors to do so in Kangaroo product. Furthermore, Australian investors have other choices in order to insulate themselves from the crisis. A European investor buying in euros has less flexibility."

But Caridia acknowledges that the Kangaroo market also often amplifies spread movements versus euro or US dollars, so that the widening some European credits experienced in Australia has been more severe than in other markets.

"The actual turnover causing spread widening in Australia was often a fraction of the turnover we see in the same credits in other markets. It's hardly surprising given the overall size and issuance volumes of the Kangaroo market versus euro or US dollars," Caridia explains.

The timing of 2011's most extreme price action was also a factor. "Late last year there were fewer dealers providing liquidity to the market, as dealers were closing down their books for year-end. Typically, the turnover in our Kangaroo bonds is very much comparable to what we measure in euros or US dollars – the outstanding being turned over more than once a year," adds Eitel.

Demand for Germany

In addition, Eitel notes the quick spread tightening after market conditions stabilised again. "So far we have benefited from the crisis, and our funding costs have improved due to the explicit guarantee from the Federal Republic of Germany and the fact that KfW is seen as a safe haven," he points out.

The same message comes from Stefan Goebel, managing director and head of treasury at Rentenbank – despite the fact that the agency is only now moving towards being an explicitly sovereign-guaranteed entity (see story on p2).

Goebel tells *KangaNews*: "Germany – and Rentenbank as a government development bank – continues to benefit from a safe haven status even though there are certain risks for the economy right now. I am very confident that Rentenbank will be able to maintain and even broaden its investor base and that we will continue to have access to cost-effective funding."

German names are very well looked after and international investors buy the names on very tight absolute yields and spreads, confirms Stefan Reiner, London-based director, financial institutions group Germany and Austria, DCM at Deutsche Bank. He adds: "They are in some ways victims of their own success: since the spreads are getting so tight investors are more and more looking for alternatives and it gets difficult to find a large investor base to buy. But in the end there are no other super-safe assets available, so investors keep buying German agencies."

Sven Lautenschläger, international funding officer at L-Bank, offers market evidence to support that claim. He tells *KangaNews*: "The demand-supply imbalance shows from the primary concessions over secondary levels. In the past we had to pay 5-10 basis points over secondary, where now we see trades priced flat to or even through secondary."

Caridia thinks the Australian market's reaction is in line with global trends in other ways. "We have seen an outperformance of German and non-European credits such as some of the supranationals. One can clearly see this trend in the issuance volumes of KfW or Rentenbank versus some of their peer group."

"There is an extremely strong bid for German public-sector assets, particularly the names that are present in Australia this year. Investors have enjoyed much lower spread volatility with these names than with some other European names. During the periods of stress we have seen over recent years, German names have benefited from the flight to quality," agrees Reid.

"INVESTORS ARE MORE AND MORE LOOKING FOR ALTERNATIVES AND IT GETS DIFFICULT TO FIND A LARGE INVESTOR BASE TO BUY. BUT IN THE END THERE ARE NO OTHER SUPER-SAFE ASSETS AVAILABLE, SO INVESTORS KEEP BUYING GERMAN AGENCIES."

STEFAN REINER DEUTSCHE BANK

Goebel points out that it is important to consider the Australian dollar market in terms of relative trading levels across major currencies. And he adds: "The attraction of our issues is defined by the absolute yield level, the spread versus govvies and swaps and our strategic approach toward this market. Ultimately, cost of funding versus Euribor also has to make sense."

German issuers are also enjoying high demand in Europe. "Investors have adjusted to more conservative investment guidelines and they are forced to invest rather than having money in an A-rated current account with a normal bank, which is why we see investors that haven't been active in the past in the euro market," says Lautenschläger. "Compared with 2008 and 2009, when investors were in the driving seat of spread, now issuers have taken over the steering wheel and are setting the spreads. They are in a much better position as a result," he adds.

According to Caridia, the range of names that have benefited from Germany's perceived safe-haven status include corporate, covered bond issuers and, most clearly, supranational, sovereign and agency (SSA) credits.

Caridia says the yield gap between German and other sovereign issuers has widened dramatically in the past year, with Bunds not just trading significantly through some of the weaker European sovereigns but also some 70 basis points through France and 10 basis points through Finland. The Bund future reached a new all-time high in July 2012.

"German triple-As such as KfW and Rentenbank have significantly outperformed their European peer group, including names to which they used to be fairly closely correlated," Caridia continues. "This outperformance of German SSAs has taken place despite an increase in supply out of the region, with new issuers such as EAA and FMS Wertmanagement coming to market this year."

Future funding

German issuers have always been among the most frequent Kangaroo borrowers. German borrowers provide the largest deal supply besides supranationals, with A$50.7 billion (US$53.4 billion) of total issuance volume between 1996 and September 2012 (see chart on this page).

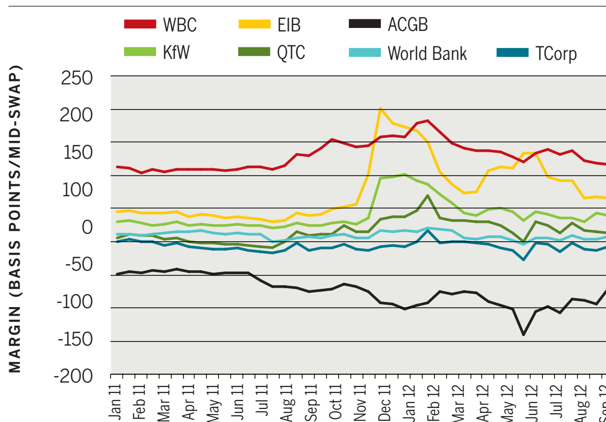
KfW is the largest Kangaroo issuer with A$30 billion raised and A$22.5 billion outstanding. "With an annual funding volume of approximately €80 billion [US$104 billion] we need to diversify our investor base and the Kangaroo market is important and strategic in this respect," Eitel says. "Most of the time this year we had to pay up versus our USD activities. But we have also proven our commitment to the market in times when we had to pay a premium compared with our euro curve."

According to Reid, if European politicians remain committed to tackle the euro area debt crisis, wider European names are likely to see a faster spread rally than the German names. "If we see confidence in a lasting solution to the debt crisis, we would expect to see a contraction of spreads between German and other European names," he says.

Over the longer term an equalisation of intra-European risk could have an impact on German borrowers. "If you ever go down the road to a European fiscal union, Germany's safe-haven status could be gone. However, the counterargument is that even in this scenario you might still have further flight to quality where investors prefer to hold bonds from Germany rather than other countries, because everything is relative," comments Stefan Schneider, Deustche Bank's chief international economist and head of macro trends.

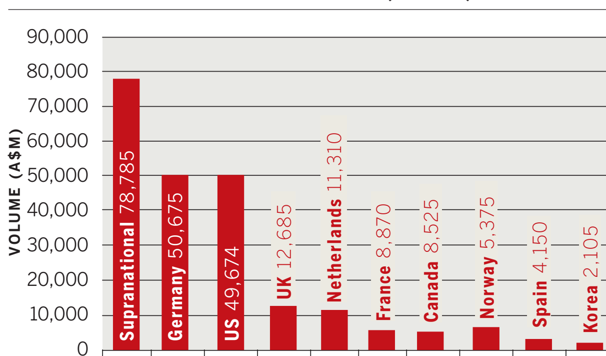
For now, being from Germany will likely continue to be a positive factor for borrowers in all global markets. "German credits will be able to access all markets in large volume at extremely favourable terms for the foreseeable future, regardless what happens to the Eurozone debt crisis. You would expect to see spread tightening in other European names as we find a solution to the Eurozone debt crisis, and consequently you would expect to see more supply in those names in Australia too," Reid tells *KangaNews*.

AUD BOND SPREAD PERFORMANCE (FIVE-YEAR MATURITY)



SOURCE: KANGANEWS, YIELDBROKER SEPTEMBER 15 2012

KANGAROO ISSUANCE BY COUNTRY (TOP 10)



SOURCE: KANGANEWS SEPTEMBER 12 2012

"GERMAN TRIPLE-As SUCH AS KFW AND RENTENBANK HAVE SIGNIFICANTLY OUTPERFORMED THEIR EUROPEAN PEER GROUP, INCLUDING NAMES TO WHICH THEY USED TO BE FAIRLY CLOSELY CORRELATED."

ALEX CARIDIA RBC CAPITAL MARKETS

still has medium-term growth potential," comments Fitch's Kiss. "Interest rates are also low and the country has all the ingredients of a declining debt path, though this can also change."

So far, Germany has been able to lift Europe upwards rather than the country being pulled down by weaker economies. "The current strength of Germany has helped all of Europe to perform a lot better," Sven Lautenschläger, international funding officer at L-Bank in Karlsruhe, tells *KangaNews*. "All the steps being taken in Europe – including the strong pressure that is being applied to weaker peripheral countries – means we are actually better off here in Europe compared with elsewhere," he adds.

As an example, Lautenschläger points out that the US has announced that it will add another US$1 trillion to its budget deficit, at the same time as the biggest deficit financers to the US – China and Japan – are both no longer generating trade surpluses sufficient to have currency reserves large enough to fund the US deficit.

Away from the sovereign itself, S&P's Banking Industry Country Risk Assessment puts Germany's economic risk lower than the average of France, Japan, the UK and the US, as well as Australia (see chart on p30).

However, Germany is not without economic challenges of its own. Hornung and Kater both note pension and healthcare liabilities that, while they will not drag down Germany's performance in the short to medium term, will eventually require additional adjustments.

Kater says both healthcare and pension systems in Germany are federal-member co-financed but governmental subsidies for pensions are €80 billion higher than healthcare, which itself accounts for approximately 11 per cent of the country's GDP. "To reduce financial pressure, the retirement age was in 2007 increased to 67 from 65. To cope with future challenges of an older population, further reforms are necessary. In the event of economic crisis the financial base of social security would erode. But even for that additional burden the German state would be strong enough," says Kater.

Germany benefits from a strong labour market, with the 5.4 per cent unemployment rate a historical low. "Compared with its European counterparts, economic growth over the medium term is not constrained by severe programmes of necessary fiscal consolidation," Kiss wrote in a report in June.

However, the makeup of Germany's economy reduces the country's ability to isolate itself from external troubles. "Traditionally, Germany has proven to be very competitive in the global market. But the flip side of this is that domestic demand has been lacklustre for years," says Hornung at Moody's. To tackle the issue, the German government has reached a series of agreements with unions to increase wages and, therefore, hopefully to kick-start domestic demand.

Acknowledging that the picture may change in a tail-risk scenario in which Germany's large trading partners in Europe are even more affected than they already are, Hornung thinks the current concern lies in the investment climate change that would likely follow a deepening euro-area debt crisis.

Meanwhile, Kater expects Germany's exports to the rest of the euro area to fall in the third quarter of 2012. He comments: "Many parts of the world economy suffer from structural or cyclical problems. China's GDP growth declined to annualised 7.6 per cent in the second quarter, the lowest since 2009. In most emerging markets, fiscal programmes are not possible because of the problems in the Eurozone right now."

Kater's projection is that Germany may enter a brief contraction for one quarter, but for 2013 he expects GDP growth of 1 per cent. A strengthening of domestic private consumption could improve the picture, he adds.

SCENARIO IMPACTS

All projections are rendered difficult, though, by the range of possible outcomes in the Eurozone – even if the ESM has somewhat lowered the chances of the more extreme negative possibilities. Schneider at Deutsche Bank explains that Germany's share of ESM capital does not add debt to Germany's government balance sheet due to the offset of the European Financial Stability Facility (EFSF). "It will only show up once there are actual write-downs due to given guarantees. This is so far ruled out by the politicians – albeit in a somewhat circular manner: if we have the large support network to keep the peripheral governments afloat, they won't have to drop out of the Eurozone and therefore there won't be a write down on the claims."

The contingent liabilities are immense, though: Kiss estimates the EFSF and ESM guarantees could cause a 7 percentage point increase in Germany's debt-to-GDP ratio, pushing the country's public debt level above 90 per cent.

A 2009 German constitutional amendment limits the structural federal government net lending-to-GDP ratio, which Kater describes as a positive signal to capital markets. However, he also points out that, in the case of extraordinary strain on the economic environment, there are exception clauses in the debt-brake rule.

The more extreme potential outcomes in Europe appear to meet any definition of extraordinary. "According to our model-based estimates, in the case of even an orderly Greek

"Having a monetary union without a fiscal union makes no sense. But what we need is a unified supervising authority for the big players in the market – not for small banks with a balance sheet of less than €50 billion."

FRANK RICHTER NRW.BANK

exit European GDP would be 1 per cent lower than in the baseline and if it was a disorderly exit it would be a range of 4-6 per cent lower," Kater says. He adds that the worst-case scenario of a complete breakup of the Eurozone would spur a deeper and longer recession than 2008.

However, Kiss is also quick to point out that there is a difference between an orderly Greek exit – one in which contagion does not spread to other Eurozone countries – and one of the worse-case outcomes. "Germany's trade relationship with Greece is really marginal so the direct impact on Germany from a Greek exit wouldn't compare to a situation in which all the EFSF capacity is used up," says Kiss. "That would be a big number despite all Germany's financial success in the past few years, and getting close to what Fitch considers consistent with our mandate limit for its AAA rating."

It is hard to make judgements on whether all member countries will stay in the EU, but keeping the single currency together is the clear preferred outcome for market participants. "I can see little good in Greece leaving the euro area. Confidence in Europe would get a serious hit and German money – in the form of bilateral loans and EFSF guarantees for Greece – would be lost for nothing, as would investments of German companies in Greece," says Alex Caridia, London-based head of SSA origination, Europe at RBC Capital Markets.

However, Kater argues that contagion effects in the case of a Greek exit could be contained. "The main question is whether European governments can prevent contagion effects to other countries. It will be avoided because European governments will convince markets that the Eurozone stands together," he says. "In the case that European governments fail to do so, the worst-case scenario is a breakup of the Eurozone with a long-lasting and deep recession. But the probability for this event is very low. The most likely situation is that the Eurozone survives the current crisis but faces a moderate recession," adds Kater.

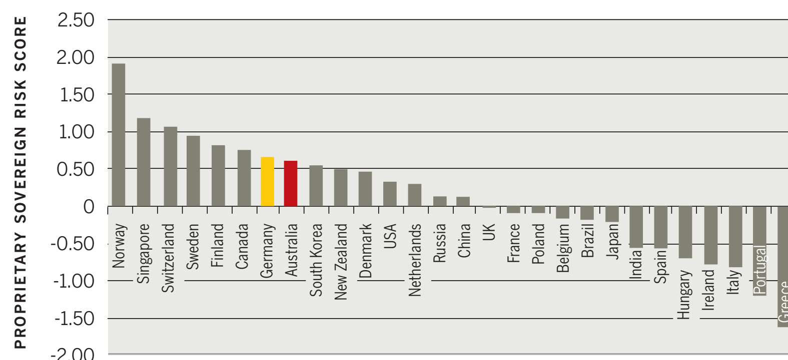
According to Hornung, Moody's baseline scenario is one in which market stress remains intermittent and policy makers are in a position to address it with incremental measures, as was the case with the establishment of the ESM.

And Kater warns that discussing the worst-case scenario could lead to an inaccurate overall picture of the situation for Germany. "This is not part of our baseline scenario and is thus not very likely. We expect the financial burden of recapitalising the banking system would be bearable for the German state," he confirms.

"It is very likely that Germany will not lose its status as a safe haven," Kater assures. "It still stands as a creditworthy country with the lowest risk exposure in Europe, so yields for Bunds will still stay low compared with other countries."

However, recent years have starkly demonstrated the fact that even what appears at a point in time to be the worst-case scenario may not be sufficient to predict future outcomes. "So many red lines have been crossed and so many things people would have never expected 12 months before have happened, so I'm really cautious on the ultimate outcome," says Deutsche Bank's Schneider.

BLACKROCK SOVEREIGN RISK INDEX



SOURCE: BLACKROCK JUNE 30 2012

THE WAY OUT

Whatever the outcome for Germany, a direction has to be found for the Eurozone debt crisis – whether the job is left to the ECB, European governments, or both. And most observers believe the only route to a long-term solution goes through the adoption of closer fiscal ties within the Eurozone (see co-published article on p18).

"Either Europe is going to a fiscal integration or the risk that it will disintegrate is pretty high. Fiscal integration is one way to get rid of the inconsistencies and hazards currently in the system," points out Schneider.

"In the long run deeper fiscal integration is very likely. Countries under financial stress will receive help in exchange for fulfilling reforms to reduce the inequalities within the Eurozone," agrees Kater. "Political power will be moved to European institutions from individual European countries."

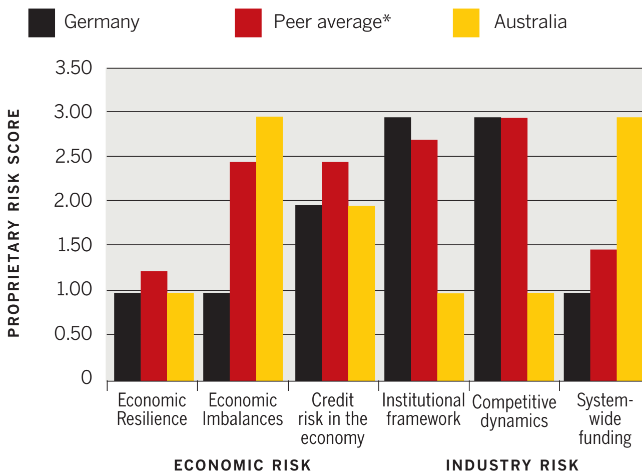
"Headline risk has increased for all markets due to the European debt crisis and the right timing for a transaction has become much more important for issuers like KfW – not only in the Kangaroo market."

KLAUS-PETER EITEL KFW BANKENGRUPPE

"All the steps being taken in Europe, including the strong pressure that's being applied to weaker peripheral countries, means we are actually better off here in Europe compared with elsewhere."

SVEN LAUTENSCHLÄGER L-BANK

S&P BANKING INDUSTRY COUNTRY RISK ASSESSMENT COMPARISON



* Peers are France, Japan, the UK and the US

SOURCE: STANDARD & POOR'S JUNE 26 2012

On the same day the road was cleared for the ESM, the European Commission proposed a single supervisory mechanism (SSM) for banks in the euro area, which will give the ECB ultimate responsibility to oversee all the 6,000 euro-area banks. Under the proposal, national supervisors will continue to be effective on a day-to-day basis in preparing and implementing ECB decisions.

Recognising the necessity of a unified banking supervisory body, Fitch's Kiss believes the effect of SSM will be limited in the short term. "The proposal for the commission will be discussed for the next few months, and the final decision will be made at the end of the year for it to come into force in 2014, so these measures are for the long run," he explains.

Despite supporting fiscal union, Düsseldorf-based Frank Richter, head of investor relations and capital markets at NRW.BANK, does not see the need to supervise small banks. "Having a monetary union without a fiscal union makes no sense. But what we need is a unified supervising authority for the big players in the market – not for small banks with a balance sheet of less than €50 billion," he tells *KangaNews*.

Hornung welcomes incremental steps. "It's relatively slow, but it's important that progress is made and the ECB finds its role in this process," he says. "In order to resolve this crisis in the medium to long term we need structural reforms in some European countries, so it is a balancing act."

Based on the imbalance between increasing resistance in northern European countries and the laggardly southern countries, Schneider warns that Europe is not ready for full fiscal union in the near future. "There is a lot of evidence that most of the countries are not really prepared to go for a fully-fledged fiscal union. They are national governments elected by their national constituents and it is hard for them to be in an extreme situation of being overruled by Brussels," he comments.

Within the wider European context, Hornung believes Germany's position is quite clear. He argues that fiscal union is only feasible when the mutualisation and centralisation of liabilities go hand in hand with a centralisation of control of assets. And he believes Germany is considering that route, but only if the control is shifted to its respected level.

"They will just have to push ahead and eventually make the whole Eurozone into a more functioning monetary union," agrees Kiss. "In Europe there are so many institutions and financial supervisions. An important block to building a healthy Eurozone is a financial union with an EU-wide regulation to be able to share the debt guarantee scheme."

What seems to be the natural outcome of a fiscal union – Euro bonds – could be another solution to the current debt crisis, suggests Richter. "This is clearly not in favour from a German's perspective. However, the alternative is the break-up of the Eurozone. A fiscal union means identifying objectives that are in common European interests and then thinking about how to finance that."

Richter believes the ECB should intervene in the secondary market across the curve, focusing on Italy and Spain first since Portugal and Ireland are already under a rescue umbrella. "The ECB needs to intervene if yields are moving beyond 7 per cent without an explicit conditionality," Richter argues. "A 400 or 500 basis points spread to Bund will get you real incentive to restructure an economy in order to achieve cheaper funding levels. That is a really nice implicit conditionality. But beyond that, levels are not sustainable."

Kiss suggests: "We need to work out what proportion of a member state's public debt can be transferred into a Euro bond. Tougher fiscal and financial stability rules, a firewall mechanism and a smoothly-functioning market are needed to avoid tension between member states. With those ingredients, the introduction of Euro bonds is a second-order issue."

Though still in its early days, Richter believes Europe is moving towards a political union. "At the end of this decade, I expect the landscape of Europe to change significantly. We have to think about how to restructure our democratic process and our election cycles. We should not transfer all political power to the Eurozone, but those in common interests should be considered." •