



Analysis of the Responses to the Eurozone Crisis

Introduction

- The crisis has underlined the role of sovereigns as lenders of last resort, with a significant crystallisation of contingent liabilities
- It has forced developed countries to use extraordinary tools, combining monetary and fiscal policies
- It has forced governments to react to short-term market pressure and re-consider their long-term economic models
- How profound will de-coupling be the second time around?

So Far A Reactive But Evolving Policy Mix

- The euro area authorities' policy framework...
 - » Crisis management measures through limited liquidity support provided by EFSF/ESM and theoretically unlimited liquidity support provided by ECB
 - » And measures to encourage growth to sustain debt service including through 'internal devaluation' (wage cuts, price cuts) and related structural reforms
- ...has failed to restore pre-crisis investor confidence...
 - » There are too many threats to growth within/outside Europe, and unknowns around restructuring
- ...which has led to increasing calls for institutional change – fiscal harmonisation and common debt issuance
 - » Policy makers currently see this as a long term solution at best
 - » And institutional change would take many years to design and implement

Market Expectations and Political Realities

- Perspective: the combined government debt of Spain, Ireland, Portugal and Greece amounts to approximately 17% of euro area GDP (nearly 40% if Italy is included)
- The euro area as a whole retains significant financial strength and has the necessary resources, incentives, and political cohesion needed to contain the growing financial pressures
- Our assumption that liquidity support for stressed sovereigns would be forthcoming has proven accurate (to date)
- Yet both 'support fatigue' and 'austerity fatigue' continue to constrain policy makers

Defaults and Exits are Highly Destabilising Options

- Policy paths for the euro area lead either to greater fiscal integration or to greater disruption, defaults and conceivably exit
 - » We do not see a sustainable middle path
- We believe fear of contagion will continue to drive the authorities to take the necessary steps to preserve the euro area
 - » Potential costs of not doing so – escalating defaults and ultimately exits – are very high given the difficulty of containing shocks
 - » Defaults create a momentum which is difficult to reverse. Exit by any country would be highly destabilising
 - » And exit by a large nation is politically and financially unthinkable. Its prospect will motivate politicians to take the necessary steps to prevent its occurrence

Integration Comes at a Cost

- High-level progress has been made on building blocks, such as allowing the ESM to recapitalise banks directly once a single banking supervision framework is in place
- Collective responsibility for supervising and supporting banks could be a meaningful step towards fiscal transfers
- The combined ESM/EFSSF framework in its current form may not be sufficient
- The contingent liabilities for supporting countries continue to rise in magnitude and will invariably lead to a deterioration in their creditworthiness
- While policy makers will ultimately succeed in normalising sovereign debt markets, the transitional period – which could last a number of years – could well see further shocks, with the risk of policy accidents and rising sovereign defaults the longer the crisis persists

Structural Reforms Have Improved External Imbalances in the Periphery But Full Resolution May Still Take Years

- The unwinding of accumulated vulnerabilities has already started in euro area countries most affected by the current crisis, even in those without formal external adjustment programmes
- The ongoing global financial crisis has triggered a reversal of current account imbalances within the euro area
 - Adjustment initially driven by a contraction in imports but increasingly by stronger exports due to improved competitiveness
- Divergence in competitiveness (in terms of labor costs) has narrowed in the past few years for some (Ireland, Spain and Portugal) but not others (Italy)
 - Competitiveness gains are partially the result of improvements in productivity that relied mostly on employment falling faster than output
- Increasing competitiveness in a sustainable fashion will depend on the effective implementation of structural reforms

Adjustment Underpinned by Growth in Exports

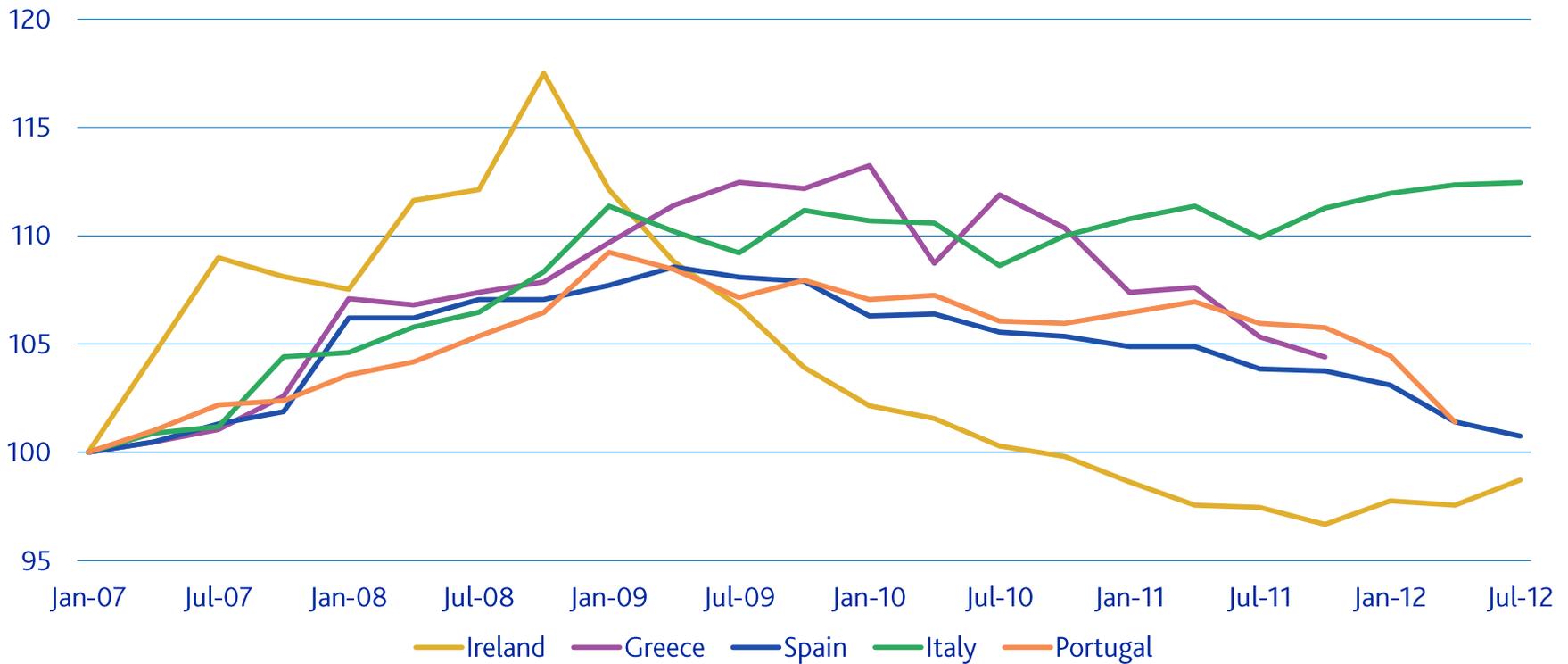
Change in Value of Exports, Imports and Domestic Demand, 2007-2012
(2007=100)



Source: Eurostat and Moody's Investors Service

Divergence in Competitiveness Narrowing

Nominal Unit Labor Costs (2007Q1=100)

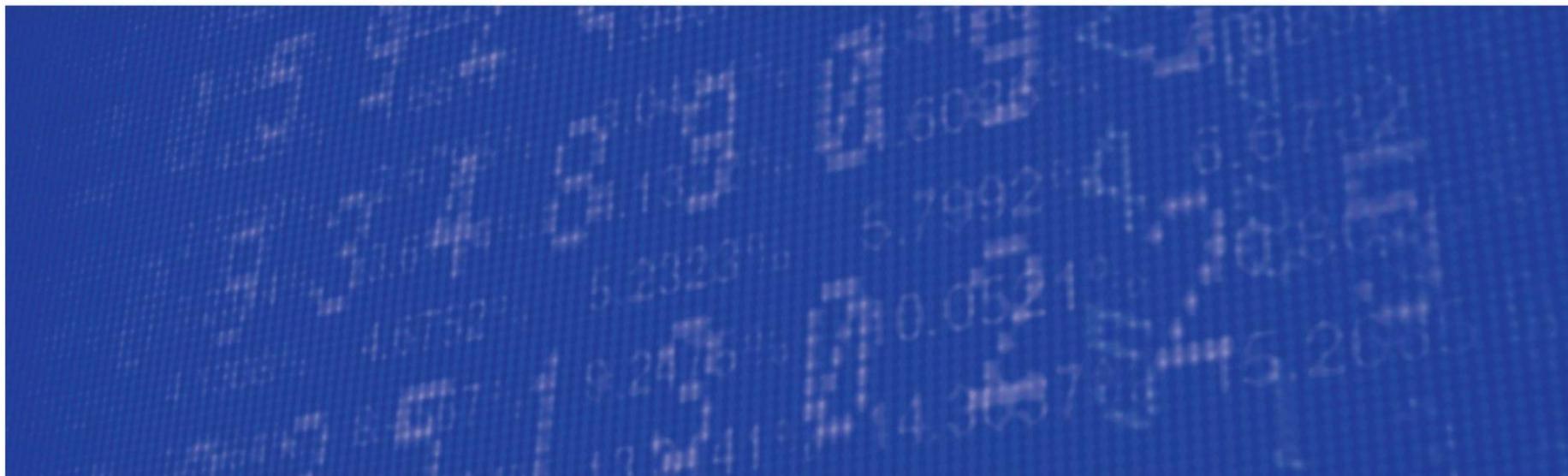


Source: Eurostat, IIF and Moody's Investors Service

Effective Implementation of Structural Reforms Key to Increasing Competitiveness

- Conditions of support programmes comprise a wide-ranging structural reform agenda
 - Largely structural reform programmes in Greece and Portugal; fundamentally limited financial-sector reform programmes in Ireland and Spain
- There is a considerable degree of implementation risk
 - This can be mitigated by significant domestic commitment and ownership of the reform process, eventually shored up by continued external reform anchors and possibly support
- Past examples (e.g. Nordics in the 1990s) show that the complete unwinding of accumulated imbalances may still take several years; especially when nominal devaluation is not available as a short-term tool

Bart Oosterveld
Managing Director
Sovereign Risk Group
Bart.Oosterveld@moodys.com
+1 (212) 553-7914



© 2012 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED,

DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Any publication into Australia of this document is by MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657, which holds Australian Financial Services License no. 336969. This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001.

Notwithstanding the foregoing, credit ratings assigned on and after October 1, 2010 by Moody's Japan K.K. ("MJKK") are MJKK's current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. In such a case, "MIS" in the foregoing statements shall be deemed to be replaced with "MJKK". MJKK is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO.

This credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be dangerous for retail investors to make any investment decision based on this credit rating. If in doubt you should contact your financial or other professional adviser.