

The Eurozone

The whole Euro project came under enormous pressure during the last month as the Greek fiscal crisis reached its zenith, spilling over to other peripheral bond markets like Spain, Portugal and Ireland. Also the Euro came under extreme selling pressure as the Euro authorities procrastinated in taking the definitive action needed and Greek default/Euro breakup seemed very real risks. However, on Sunday May 9th the EU came up with a sizeable and far-reaching plan.

The total cash amount potentially available is €750B or 8.2% of 2010 Eurozone GDP, €250B of which coming from the IMF. It would take the form of conditional loans through (1) the EU budget and (2) a special purpose vehicle (SPV).

The European Commission will increase its balance of payments facility by €60B to €110B of capital. The IMF will add €60B. This facility will be available for the first time to Eurozone countries and is likely to be available rapidly, although governments can make bridge loans on a short-term basis should imminent funding needs arise.

The Eurozone countries also reached an intergovernmental agreement, which will set up an SPV. The SPV will work through loan guarantees. Any payouts will be tied to strong conditions, acting together with the IMF. The total amount is of up to €440B with an additional IMF contribution of at least €220B. Looking at this facility relative to the funding needs of the periphery, it covers either the funding needs of Spain, Portugal and Ireland together up until well after the end of 2013.

In addition, the ECB Governing Council decided to conduct interventions in the euro area public and private debt securities, subject to commitment by governments on their fiscal plans. No amounts were announced, which leaves the ECB with complete freedom to act. Also the ECB will not only buy public sector paper but also private sector, a major development. Unsurprisingly, the ECB will sterilise these operations to avoid any impact on the monetary base and so on inflation. The ECB also reopened swap and term operations. It will conduct two 3M operations at fixed rates (on May 26th and June 30th), one 6M operation (on May 12th).

This plan shows a belated sense of solidarity by the Eurozone governments and institutions, along with the IMF. It is a major backstop facility for Eurozone sovereigns and will provide ample breathing space to implement fiscal consolidation measures, which are expected to be stepped up in coming weeks. A word of caution, though, the longer term requirement for extreme fiscal action to reduce the debt burdens of the periphery will be tough, with much interference now by the EU and IMF. There will be negative second order effects on growth, implying an arduous path to recovery. Ireland thankfully took early steps to rein in the deficit, but this is a multi-year process.

| At end of year | 2009 | 2010 |
|----------------|--------|--------|
| Germany | -3.2% | -6.3% |
| France | -8.0% | -7.5% |
| Italy | -5.5% | -5.4% |
| Spain | -11.4% | -10.2% |
| Greece | -12.7% | -8.7% |
| Portugal | -9.5% | -8.3% |
| Ireland | -11.5% | -10.5% |

Important Information

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