

Greek debt debate: a new euro crisis ahead?

- After a period of relative calm, the **euro debt crisis may again rattle markets** in the next two months. With his comments about a “**voluntary restructuring**” of Greek public debt, German finance minister Schäuble seems to have served notice (1) that Germany would not be willing to support Greece beyond the current €110bn EU/IMF programme and (2) that Germany may want to discuss debt restructuring before it ratifies the envisaged “grand bargain” on a permanent solution to the European debt crisis later this year.
- Greece is not the major issue. Relative to the size of the euro economy, Greece and its public debt burden are tiny. **The key issue is contagion.** After Schäuble’s remarks, yield spreads for Spain and Italy over Bunds widened very significantly.
- Europe is heading for **important milestones in June:** (1) The EU/IMF/ECB troika will deliver their new verdict on the Greek efforts, (2) Europe will publish the results of new bank stress tests, and (3) EU leaders want to finalise their “grand Euro bargain”.
- The IMF expects the Greek **debt-to-GDP ratio** to peak at 158% in 2011. The €110bn EU/IMF support funds will probably be spent by mid-2012. Unless yields on Greek bonds were to fall dramatically, Greece could not afford to finance itself on the market.
- **Our own view** remains that it would be premature to restructure Greek debt now. (1) We should not judge fiscal sustainability at the trough of a deep recession. Whether or not a Greek default is inevitable will become clear only after the return to growth. (2) The contagion risks are still far too serious. The more time we give Spain and Ireland to turn their own fiscal positions around convincingly before we make a final judgement on Greece, the smaller would be the risk of a Lehman-style chain reaction to a potential Greek default.
- Greece has taken **courageous steps** to make its fiscal position sustainable. Adjusted for the impact of recession, the fiscal deficit fell by 9% points of GDP last year. More is in the pipeline. This is one of the most dramatic fiscal turnarounds in an advanced economy ever.
- Greece has just presented a plan to reduce the **2011 fiscal shortfall** by an additional 1% of GDP and to raise **privatisation revenues** by an additional €37.5bn. This could reduce its public debt by 16% of GDP.
- Much more could be done to help Greece to avoid default. The **ECB** would reap a major **windfall profit** on its holdings of Greek public debt if Greece does not default. The ECB could commit itself to use any such windfall gain to de facto reduce the Greek debt burden if Greece adheres to its austerity and reform programme. Also, the **IMF** could signal more clearly that it may support a fiscally compliant Greece beyond mid-2012 even without further EU funds.
- However, Schäuble’s comments may signal a loss of patience. The already substantial risk that policy makers may want “to get over with it” and **restructure Greek debt this summer** has risen further. If so, a **mild default**, that is a **lengthening of maturities** and a cut in yields, still looks more likely than an outright haircut. But the risk of a **serious haircut** on Greek debt later this year is also quite significant.

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18 April 2011
Dr Holger Schmieding
Chief Economist
+44 20 3207 7889
holger.schmieding@berenberg.com

The starting situation

The Hellenic Republic lost its access to capital markets in April 2010. Its public debt amounts to €330bn. Of the €290bn debt in central government securities, an undisclosed amount – perhaps up to a nominal value €40bn – may be held by the Eurosystem, that is the ECB and its member central banks. Greece is currently financed by an EU/IMF support programme over €110bn. The money is likely to run out in mid-2012. On current plans, Greece would need to raise some €25-30bn on the market again at some time in 2012. At current yields of 13.6% for Greek 10-year paper and almost 17.4% for two-year paper, this looks unaffordable for Greece.

The money for Greece may run out in mid-2012

Fiscal adjustment

Greece has taken many courageous steps to make its fiscal position sustainable. According to IMF estimates (IMF Fiscal Monitor April 2011), Greece slashed its general government deficit from a runaway 15.4% of GDP in 2009 to a still extremely high 9.6% in 2010. At the same time, the economy contracted by roughly 4.5%. The underlying fiscal position, the cyclically adjusted primary balance, improved by 9% points from a deficit of 12.0% in 2009 to 3.1% in 2010. As many fiscal measures, such as some of the tax hikes, kicked in only over the course of 2010, the full-year data for 2010 probably understate the genuine fiscal adjustment. We expect that, on unchanged policies, a further 2% improvement in the underlying fiscal balance is already in the pipeline, bringing the total Greek fiscal adjustment to date to 11% of GDP. That is probably one of the most dramatic fiscal turnarounds in an advanced economy ever in times of peace, following an also fairly dramatic worsening in the years before.

Greece: impressive fiscal adjustment

The underlying improvement does not show up fully in the headline data. In the first three months of 2011, revenues for the Greek state budget fell 8.1% year-on-year according to the monthly budget execution report by the Hellenic Ministry of Finance. At the same time, expenditures rose 7.8%. As a result, the state deficit came in at €4.71bn, above the €4.37bn recorded at the same time last year. However, the result is almost fully in line with the budget, which had set a deficit target of €4.70bn for the first quarter. The slippage relative to early last year probably mirrors (1) the very weak economy, (2) a base effect because Greece postponed some expenditures in early 2010 while it was struggling to avoid a call for outside help, and possibly (3) the late timing of the Easter tourist season in 2011.

But some slippage in early 2011

The state budget is a narrower definition of the fiscal deficit than the general government deficit, which is used to assess the overall fiscal position as discussed above. For example, the wider definition includes many state-owned enterprises under direct government control. On this count, Greece is reporting some significant progress. For 18 state-owned enterprises with detailed data, the total reported loss fell from €225m in the first two months of 2010 to €89m in the same period this year, according to the Greek ministry of finance.

State-owned companies are cutting their losses

On 15 April, Greece presented a medium-term fiscal plan until 2015 with further austerity of €3bn for 2011 (1% of GDP) and a detailed privatisation plan with revenues of €50bn until 2015. Such revenues would

Ambitious medium-term plan to stave off a default

be €37.5bn beyond the revenue target in the EU/IMF programme, equivalent to a potential debt reduction of 16% of Greek GDP.

Economic situation

The need for savage austerity pushed the Greek economy back into a deep recession last year. In Q4 2010, the economy contracted by 6.6% yoy, bringing the total cumulative decline in activity since the pre-Lehman peak in H2 2008 to 7.2%.

Austerity has pushed Greece back into a deep recession

Leading economic indicators hit a trough right after Greece had to ask for help in April 2010. The EU Commission sentiment survey for Greece has recovered modestly from an average of 72.6 in Q2 2010 to 78.0 in Q1 2011. This points to a lessening recession but not yet to an imminent economic upturn (Chart 1). Greece is miles behind the euro zone average.

Leading indicators have turned up slightly since mid-2010...

Chart 1: Greece far behind the euro average



...but remain at very depressed levels

Source: EU Commission surveys

What is at stake?

The IMF expects the Greek debt-to-GDP ratio to peak at 158% of GDP in 2012. If Greece had to pay, say, 10% interest on its debt to find buyers, it would eventually have to spend almost 16% of GDP on interest payments, up from 6.4% in 2010. At average yields well above 7%, the Greek fiscal position looks unsustainable. No wonder that almost all observers expect that Greece will be forced to restructure its public debt eventually.

At yields well above 7%, the Greek fiscal situation looks unsustainable

Greece itself is tiny. It accounts for 2.5% of euro zone GDP. If Greece were to slash the face value of its outstanding public debt by 50%, the total hit would be equivalent to 1.8% of annual euro zone GDP. This is within the margin of monthly equity market fluctuations in the region.

Greece itself is tiny

The real issue is contagion. Schäuble may have triggered a new round of the euro debt crisis. A restructuring of Greek debt would set a precedent. On Thursday, 14 April, the market interpreted comments by German finance minister Schäuble in “Die Welt” as a sign that Germany may want

The real issue is contagion

Greece to restructure its debt, possibly after a June 2011 EU/IMF assessment of Greek fiscal sustainability. By Monday morning, 10-year spreads over German Bunds had widened by 45bp for Spain and 21bp for Italy – that is, for two countries with much bigger bond markets which are not covered by current IMF/EU assistance programmes.

A haircut on Greek debt is not a cheap and easy solution to the euro debt crisis, as we argued in more detail in our report “On the right track: coping with the European debt crisis”, 8 February 2011.

- It would be only of modest help for Greece in the near term. First, Greece would immediately need to **raise fresh capital** to recapitalise its banks. Borrowing on the market at acceptable conditions right after a haircut for bondholders would be a challenge, to put it rather mildly. Greece would also probably still have to borrow to cover its running government expenses and residual debt service.
- Europe would need to stop contagion in its tracks. To avoid a chain reaction, it would have to make it very credible that only Greece (or only Greece and Ireland? or only Greece, Ireland and Portugal?) would be subject to debt restructuring. To signal such a commitment, Europe and the IMF would immediately have to put in place a **huge and credible support system**. Whether the current EFSF and the envisaged ESM with a total lending capacity of €500bn would suffice to re-assure markets about Spain, Italy and Belgium is at least an open question.
- Also, European governments may immediately have to recapitalise some of their exposed banks to avoid a new wave of concerns about the fragility of domestic banking systems, for instance in Spain and Germany. This might be a particular concern for some of the major German banks that are de facto owned or have been taken over by the state and for French banks owning subsidiaries in Greece.

A haircut would not be cheap and easy:

Greece would still have to borrow

Europe would immediately need a strong defence against contagion risks

And what about the banks?

The positions of the major players

Until late 2010, all relevant officials seemed to stick to the view that Greece will not need to restructure its debt and that any sovereign default in the euro zone could trigger a Lehman-style chain reaction in financial markets and the real economy. Such a nightmare ought to be avoided. Since then, the taboo of not contemplating a default has been broken.

The taboo has been broken – at least verbally

The deeper-than-expected recession in Greece and some revisions to the starting level of Greek debt, largely by including further state-owned enterprises in the count for the general government sector, have made the task ahead for Greece look even more daunting. The rise in Greek bond yields reflects this. In addition, the gradual if somewhat patchy healing process in the euro zone has made policy makers less afraid of contagion risks. Banks could probably stomach a Greek hit now less badly than a year ago.

A daunting task ahead

Our admittedly hazy perception of the position of the major players:

- The **European Central Bank** and the **Greek government** remain strongly opposed to any debt restructuring.
- The **International Monetary Fund** and the **EU Commission** are open to discussions about a potential debt restructuring if ways can be found to contain contagion risks.
- **Euro zone finance ministers** are also open to such discussions. Especially policy makers of some AAA-rated countries, which are the ones to underpin the whole euro-support mechanisms, are losing their patience and are thinking about a possible debt restructuring. Other finance ministers (from AAA-rated France as well as other nations?) still seem to be reluctant to entertain the idea.
- In **Greece**, parts of the business community and some parliamentarians of the ruling Socialist Party are also apparently ready to discuss a debt restructuring as a potential way to ease the need for austerity and thus the adjustment pain, judging by reports in Greek “Kathimerini” newspaper.

The ECB is against it

But some major players are no longer ruling out a debt restructuring

The German position: the Schäuble quotes

As usual in post-Lehman Europe, the position of Germany – the major paymaster – is of particular importance.

German finance minister Schäuble is an old political fox. He tends to choose his words with care, knowing the impact they can have. His comments on Greek sustainability in “Die Welt” are worth quoting: “The prerequisite for any support programme is that the IMF, the ECB and the EU Commission confirm the debt sustainability of the country in question... The next progress report is due in June. I expect a detailed analysis of the debt sustainability of Greece. If this report should conclude that the debt sustainability is in doubt, something has to be done” [our translation].

The Schäuble quotes: “restructuring on a voluntary basis”

Asked directly about a haircut on Greek debt, Schäuble went on: “From 2013 onwards, private creditors have to be aware that they could be at risk for new bonds. The European Council has agreed on this. Until then, a restructuring could only work on a voluntary basis.”

Schäuble did not reject outright the idea of a restructuring of Greek debt pre-2013. Instead, he publicly mentioned it as a potential option on a “voluntary basis”. That is the key news from this interview.

Schäuble’s views do not always prevail in the German debate. For example, he had initially argued against involving the IMF in the euro debt crisis. Our fairly hazy perception of the position of other key players in Germany is that many policy makers doubt that Greece can make it without debt restructuring. Many parliamentarians from the ruling CDU/CSU-FDP coalition seem to be very unwilling to extend aid to Greece beyond the current €110bn EU/IMF programme, with a German share of €22.4bn in the form of federal guarantees for KfW loans to Greece. If Greece could not finance itself on the market later in 2012 once the current €110bn are

The view from Berlin: no more German money for Greece beyond the current programme?

spent, Germany may not approve a Greek request to tap EFSF funds. As support for the periphery is not highly popular, any additional aid for Greece might only be feasible if “the banks” are seen to suffer, for instance by having to bear a haircut on their holdings of Greek debt.

In the same vein, **if Berlin could present a haircut on Greek debt as a measure that would hit banks much more than taxpayers, such a “burden sharing” may make it easier for government leaders to get the “grand bargain” on a comprehensive solution to the European debt crisis through the two houses of German parliament.** However, if Berlin would have to immediately recapitalise some of the state-owned banks for such losses, it may not be very popular either.

Hitting the banks with a haircut on Greek debt could help Berlin in the domestic political debate

A “voluntary restructuring” of Greek public debt, as mentioned by Schäuble, may have a further potential advantage for Germany and the other euro countries currently supporting Greece. Although their loans to Greece are not senior to Greek government bonds, these countries may potentially claim that in “voluntary” negotiations between Greece and the holders of Greek bonds, the bilateral support loans should be treated more leniently, reducing the loss for their taxpayers. As a bargaining chip in such negotiations, the official lenders could point out that, in the absence of an official backstop facility, losses for private bond holders would have been even much worse.

Easy on the German taxpayers?

ECB: crucial player in a very peculiar position

Within Europe, the European Central Bank (ECB) is arguably the most powerful economic institution. On 8 May 2010, its blank refusal to contemplate purchases of government debt triggered the market panic that forced Europe and the IMF to come up with a €750bn support package over a weekend. Substantial Eurosystem purchases of Greek debt right thereafter then helped to quell the panic. A public dispute about such debt purchases has by now cost Bundesbank president Weber, the then leading candidate to become ECB president in November 2011, his job.

The critical role of the ECB

The ECB has brought itself into a peculiar position.

- The ECB has taken a strong and publicly stated view: Concerned about contagion risks, the ECB is very much against any debt restructuring.
- The Eurosystem, that is the ECB and its member central banks, stand to reap a major windfall profit if Greece did not restructure its debt.
- The ECB is part of the troika (with the IMF and EU Commission) that judges the debt sustainability and the fiscal progress of Greece.
- The ECB is also the leading advisor to the European Council of finance ministers and European summits as the ECB participates in their discussions on the European debt crisis.

A potential conflict of interest:

The ECB stands to reap major windfall gains as long as Greece services its debt...

...but is also judge and advisor on Greek matter

We have no information as to how much Greek public debt the Eurosystem has bought and the interest which it is earning. A conservative guess may be that, of the total €76bn which the Eurosystem has spent on

How much does the Eurosystem own?

purchases of government bonds since mid-May 2010, €30bn may have been for Greek paper. At purchasing prices of around 75 cents to the euro, the nominal amount would then be €40bn. If Greece repaid this debt upon maturity in full, the Eurosystem would reap a windfall profit of €10bn. Being probably the biggest single holder of Greek bonds, and the one that bought at depressed post-April 2010 prices rather than at face value, the Eurosystem would probably be the major single beneficiary by far if Greece serviced its debt in full. In addition, the interest which the Eurosystem earns on these bonds (perhaps average annual coupon payments of about 8% relative to the price at which the Eurosystem bought the bonds?) is well above the rate which the IMF and the EU charge Greece for support loans.

The peculiar position of the ECB impairs the credibility of the advice which the ECB gives to other policy makers. ECB advice can be seen as tainted by its self-interest to avoid losses on its holdings and reap a windfall profit instead.

This peculiar position gives the ECB and its member central banks the chance to strengthen their own credibility and support the Greek adjustment programme with one fell swoop: The Eurosystem could use any profit it stands to make on its holdings of Greek bonds to ease the Greek burden.

More precisely, the Eurosystem could

- publicly disclose its precise holdings of Greek debt, including the prices at which it bought the paper,
- promise to re-invest any principal repayments to buy Greek debt on the secondary market at market prices, and
- promise also to use any coupon payments beyond a yield equivalent to the rate which the EU/IMF charge for their support loans to buy Greek public debt on the secondary market,

for a period of time equivalent to the longest maturity of EU/IMF support loans to Greece, as long as Greece faithfully abides by its fiscal adjustment and reform programme.

Over time, this would de facto redistribute the hypothetical Eurosystem windfall profits from the owners of the Eurosystem, the 17 member governments, to Greece. In its impact, it would be comparable to a conditional debt relief. De facto, the Eurosystem would cut the outstanding Greek public debt by the difference between the face value and the purchasing price of the Greek debt held by the Eurosystem. If the Eurosystem had in fact spent €30bn to buy €40bn of such debt, the difference would be €10bn, equivalent to 4% of Greek GDP. This could send a strong signal of support for a fiscally compliant Greece and mitigate somewhat the apparent Eurosystem self-interest in avoiding a Greek default.

In a related step, the ECB could delegate the verdict if Greece is actually complying with its obligations and thus qualifies for such conditional Eurosystem debt relief to the IMF.

The potential conflict of interest could impair the credibility of ECB advice

The Eurosystem could help Greece a lot and enhance its credibility at the same time...

...if it donates all windfall profits from its Greek debt holdings to Greece...

...as long as Greece faithfully implements its austerity and reform programme

De facto debt relief – but only for a fiscally compliant Greece

Critical milestones in June

For four reasons, the discussion about a Greek debt restructuring could intensify in the run-up to June.

Four reasons why June could be interesting

1. The troika of IMF, EU Commission and ECB will present their latest assessment of Greek progress in June.
2. By that time, the troika will have taken a close look at the new measures which Greece proposed on 15 April, and will have some idea whether the Greek government will be able to fully get these proposals through parliament.
3. Europe will publish the results of its bank stress tests in June. The exercise will give the authorities – and markets – a better idea of bank exposure and the potential need to recapitalise banks in the case of a Greek default.
4. The European Union wants to finalise its “grand bargain” on a comprehensive solution to the euro debt crisis in June. Some details of the envisaged new support mechanism (ESM) to take over from the current temporary facility (EFSF) in mid-2013 and the way to raise the effective borrowing capacity of the EFSF to its full notional €440bn were left open at the two EU summits in March. In the European discussions and the parliamentary ratification procedures, the issue of debt sustainability looks set to come up.

Progress report on Greece

A close look at the new Greek programme

Bank stress test results

Finalising the “grand bargain”

The Greek issue may or may not be resolved one way or the other in June or shortly thereafter. However, **markets probably have to brace themselves for a noisy debate about debt restructuring.** The euro debt crisis, which had become less of a market concern so far this year, may well turn into a significant market mover again. Not for the first time, nervous reactions in markets could force politicians to make up their mind and agree on the European level earlier than they had initially intended.

Markets have to brace themselves for a lot of noise

Our own view: give Greece time to show results

Our own view as to what Europe should do remains unchanged from our in-depth report on the European debt crisis from 8 February.

1. Greece may or may not have to restructure its public debt in the end. But we should not decide the issue in the middle of a deep recession. Whether or not Greece will have to default will become apparent only once the economy has moved back to growth and the medium-term fiscal outlook becomes clearer. Two years ago, hardly any outside observer had believed that the Baltic countries could maintain their currency peg to the euro. By now, a rebounding Estonia is a proud member of the euro zone and Latvia and Lithuania are recovering at an impressive speed, with their currency regimes intact. We would thus defer the final judgement on Greek debt sustainability until close to the end of the current support programme for Greece.

Our view: do not force the issue in the middle of a deep recession

2. **Contagion risks** remain serious. The risk that a Greek default could set off a Lehman-style chain reaction is probably much lower than it was 12 or six months ago. But it is still not negligible. The best way to contain contagion risks is to let other countries return to better health before subjecting them to the contagion risk. The more time we give, say, Spain and Ireland to show the results of their own efforts, the better the chances that markets will not lump them together with Greece in case of a Greek default.

Remember that contagion is the key issue

In short, we think that the euro zone response to the crisis has so far contained the contagion risks fairly well. It has not failed. Whether or not Greek debt will have to be restructured should not be decided this year already. If Greece were to need more support in mid-2012, such further official credits should be senior to any private-sector claims in order to cap the exposure of taxpayers to Greek risks.

Why pass judgement this year already?

The need to restructure is not a foregone conclusion

It is quite possible that a Greek debt restructuring may become inevitable at some point in the future. But this is not a foregone conclusion.

Greek debt restructuring may or may not be inevitable in the end...

Suppose that the Greek debt ratio rose to 158% at the end of 2012, as the IMF projects. If we adjust this for discounted revenues from the additional Greek privatisations planned until 2015 (allowing for some slippage) and for the de facto debt relief by the Eurosystem which we have proposed above, the hypothetical debt ratio would come down to 140% of Greek GDP. Of that, more than one third – probably an amount close to 55% of Greek GDP – would be held official creditors (IMF, euro members, Eurosystem). With an interest rate on such officially held debt set at, say, 5%, the task to finance the remaining debt worth 85% of Greek GDP on the market after 2012 would look much less daunting.

...but there are still many steps which Greece and its official creditors could take to improve the outlook

Suppose that Greece had to pay an average interest rate of 7% on its debt held outside official institutions. With most of the outstanding debt having much lower coupons, this would easily cover hypothetical financing costs of 8% or slightly more for new long-dated bonds in the initial post-2012 period. That would leave the Greek interest burden at 8.7% of its GDP. Relative to the 6.4% Greece already paid in recession year 2010, the increase to 8.7% could be a bearable additional burden. Over time, financing costs would probably come down if Greece stays the course of prudence.

The debt dynamics may still be manageable in the end – it is simply too early to know

The IMF could help without Europe

A further step could enhance market confidence: Amid growing resistance in Europe to further bail-out packages, both Europe and the IMF could declare that Europe would raise no objections if the IMF were to provide some further conditional and temporary assistance to Greece once the current joint EU/IMF programme may otherwise run out of money around mid-2012. As IMF funds are always senior to private-sector claims, this would add only very modestly to the effective risk borne by European taxpayers. It would give Greece more time to show results. Judging by comments from some IMF officials, including its chief economist John Lipsky in newspaper interviews in early April 2011, the IMF may be ready to grant Greece a supplementary programme.

A potential additional programme funded solely by the IMF may give Greece precious extra time

What may happen next?

What may happen could, of course, be rather different from what we think would be best. The “no default” taboo has been broken in the discussion. Schäuble’s comments show that the debate is slowly moving towards a restructuring of debt.

The policy debate is moving towards a Greek default

As we noted in our 8 February 2011 study, “the current political and market debate suggests a high risk that Greece will be asked to restructure its public debt even if the economic case for doing so is not convincing”. The risk has risen further since then.

If Greece had to restructure its debt, an outright haircut of, say, 50% would ease the public debt burden substantially. But it would also trigger an immediate need to recapitalise banks in Greece and beyond. It could have severe contagion risks and would potentially be quite costly for European taxpayers. Judging by the way the debate is moving, such an outcome is quite possible, though.

Even a substantial haircut is quite possible

Still, Europe is usually not given to take such harsh decisions except under extreme duress. A Europe with conflicting views internally usually heads for compromises. The milder “compromise” version of a Greek debt restructuring could be a significant lengthening of maturities coupled with reduced coupon payments. For most purposes, this would avoid the need for immediate and huge up-front write-downs. It would thus be far less damaging to bank balance sheets and less visible to taxpayers. The ECB may also find it much easier to agree to such debt restructuring rather than to an outright haircut.

A milder alternative: a major extension of maturities coupled with lower coupon payments

We would not be surprised if the discussion about Greece were to move in this direction this summer, that is well before the current €110bn support funds for Greece will likely be exhausted in mid-2012. An outright haircut would then be a fall-back option if this milder version of default does not yield sufficient results. But again, the risk that impatient policy makers will pull the trigger prematurely and impose a premature and possibly avoidable haircut on Greek debt is substantial. **The discussion – and the contagion risks which such a discussion may trigger – looks set to intensify in the next few months.**

The default discussion – and the contagion risks from such a discussion – looks set to intensify in the next two months

The result of the Finnish election on 17 April, in which the Euro-sceptic “True Finns” party increased its share of the vote from 4% to 19%, has also raised eyebrows across Europe. But even if Finland were to voice objections, for instance against a support package for Portugal, this need not derail the process. For example, the initial Slovak objections against aid to Greece did not really affect the process of passing a support package for Greece much last year. Europe usually finds a way to deal with objections by smaller member states without derailing its most important projects. Still, the major point remains: the euro debt crisis could move back into market focus in the next few months.

What about Helsinki?

Contacts: Investment Banking

Equity Research

AUTOMOTIVE

David Cramer	+44 (0) 20 3207 7887
Mark Mackenzie	+44 (0) 20 3207 7861
Alay Patel	+44 (0) 20 3207 7821

BANKS

Nick Anderson	+44 (0) 20 3207 7838
Pedro Fonseca	+44 (0) 20 3207 7930
Thomas Faeh	+44 (0) 20 3207 7915
Alex Potter	+44 (0) 20 3207 7919

BUSINESS SERVICES

William Foggon	+44 (0) 20 3207 7882
Konrad Zomer	+44 (0) 20 3207 7920

CAPITAL GOODS

Simon Goetschmann	+44 (0) 20 3207 7856
Stephan Klepp	+44 (0) 20 3207 7884
William Mackie	+44 (0) 20 3207 7837
Margaret Paxton	+44 (0) 20 3207 7934
Dominik Podewils-Duerniz	+44 (0) 20 3207 7854

CHEMICALS

Jaideep Pandya	+44 (0) 20 3207 7890
----------------	----------------------

CHIEF ECONOMIST

Dr. Holger Schmieding	+44 (0) 20 3207 7889
-----------------------	----------------------

CONSTRUCTION

Robert Muir	+44 (0) 20 3207 7860
-------------	----------------------

DIVERSIFIED FINANCIALS

Richard Perrott	+44 (0) 20 3207 7925
-----------------	----------------------

Sales

Specialist Sales

CONSUMER GOODS

Alix Turner	+44 (0) 20 3207 7817
-------------	----------------------

FINANCIALS

Philip Pickard	+44 (0) 20 3207 7828
----------------	----------------------

HEALTHCARE

Frazer Hall	+44 (0) 20 3207 7875
Andrew Holder	+44 (0) 20 3207 7815

Sales

LONDON

John von Berenberg-Consruch	+44 (0) 20 3207 7805
Matt Chawner	+44 (0) 20 3207 7847
Simon Chisholm	+44 (0) 20 3207 7801
Jeremy Gardiner	+44 (0) 20 3207 7808
Ben Hutton	+44 (0) 20 3207 7804
Andrew McNally	+44 (0) 20 3207 7802
David Mortlock	+44 (0) 20 3207 7850
Peter Nichols	+44 (0) 20 3207 7810
Kieran O'Sullivan (US)	+44 (0) 20 3207 7803
Max von Doetinchem	+44 (0) 20 3207 7826

ZURICH

Stephan Hofer	+41 (0) 44 283 2029
Carsten Kinder	+41 (0) 44 283 2024
Gianni Lavigna	+41 (0) 44 283 2038
Benjamin Stillfried	+41 (0) 44 283 2033

FOOD & BEVERAGE

Jafar Alam	+44 (0) 20 3207 7827
Philip Morrissey	+44 (0) 20 3207 7892
Anna Patrice	+44 (0) 20 3207 7863
James Targett	+44 (0) 20 3207 7873

FOOD RETAIL

Arnaud Cavigioli	+44 (0) 20 3207 7848
Niamh McSherry	+44 (0) 20 3207 7836

HEALTHCARE

Scott Bardo	+44 (0) 20 3207 7869
Alistair Campbell	+44 (0) 20 3207 7876
James Harvey	+44 (0) 20 3207 7885
Adrian Howd	+44 (0) 20 3207 7874
Tom Jones	+44 (0) 20 3207 7877

INSURANCE

Michael Broom	+44 (0) 20 3207 7872
Tom Carstairs	+44 (0) 20 3207 7823
Peter Eliot	+44 (0) 20 3207 7880
Trevor Moss	+44 (0) 20 3207 7893
Sami Taipalus	+44 (0) 20 3207 7866

LUXURY GOODS

Seth Peterson	+44 (0) 20 3207 7891
---------------	----------------------

MEDIA

Jonathan Helliwell	+44 (0) 20 3207 7865
Sarah Simon	+44 (0) 20 3207 7830

MID-CAP CONSUMER

Anna Patrice	+44 (0) 20 3207 7863
Trion Reid	+44 (0) 20 3207 7881

INDUSTRIALS

Chris Armstrong	+44 (0) 20 3207 7809
-----------------	----------------------

INSURANCE

Matthew Wright	+44 (0) 20 3207 7807
----------------	----------------------

TECHNOLOGY & MEDIA

Daegal Tsang	+44 (0) 20 3207 7822
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HAMBURG / FRANKFURT

André Grosskurth	+49 (0) 40 350 60 584
Susette Mantzel	+49 (0) 40 350 60 694
Marco Weiss	+49 (0) 40 350 60 719

PARIS

Christophe Choquart	+33 (0) 1 5844 9508
Arnaud Doré	+33 (0) 1 5844 9511
Dalila Farigoule	+33 (0) 1 5844 9510
Edouard Landau	+33 (0) 1 5844 9513
Olivier Thibert	+33 (0) 1 5844 9512

CRM

LONDON

Greg Swallow	+44 (0) 20 3207 7833
Sophy Mills	+44 (0) 20 3207 7834
Sandra Bode	+49 (0) 40 350 60 459

MID-CAP GENERAL

Gunnar Cohrs	+44 (0) 20 3207 7894
Benjamin Glaeser	+44 (0) 20 3207 7918
Bjoern Lippe	+44 (0) 20 3207 7845
Alexandra Roche	+44 (0) 20 3207 7879
Alexandra Schlegel	+44 (0) 20 3207 7896

OIL & GAS

Neill Morton	+44 (0) 20 3207 7812
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REAL ESTATE

Kai Klose	+44 (0) 20 3207 7888
Estelle Weingrod	+44 (0) 20 3207 7931

STEEL

John Philipp Klein	+44 (0) 20 3207 7895
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SUSTAINABLES

Lars Dannenberg	+44 (0) 20 3207 7855
-----------------	----------------------

TECHNOLOGY

Adnaan Ahmad	+44 (0) 20 3207 7851
Jean Beaubois	+44 (0) 20 3207 7835
Ali Khwaja	+44 (0) 20 3207 7852
Zhancheng Li	+44 (0) 20 3207 7853

TELECOMMUNICATIONS

Wassil El Hebil	+44 (0) 20 3207 7862
Usman Ghazi	+44 (0) 20 3207 7824
Stuart Gordon	+44 (0) 20 3207 7858
Paul Marsch	+44 (0) 20 3207 7857
Barry Zeitoune	+44 (0) 20 3207 7859

TOBACCO & HPC

Erik Bloomquist	+44 (0) 20 3207 7870
-----------------	----------------------

UTILITIES

Benita Barretto	+44 (0) 20 3207 7829
Ana Gaspar	+44 (0) 20 3207 7814

TELECOMMUNICATIONS

Mandeep Singh	+44 (0) 20 3207 7816
---------------	----------------------

UTILITIES

Kader Hidra	+44 (0) 20 3207 7818
-------------	----------------------

Sales Trading

HAMBURG

Nils Carstens	+49 (0) 40 350 60 563
Oliver Garbe	+49 (0) 40 350 60 358
Fin Schaffer	+49 (0) 40 350 60 596
Hanns-Christian von Schuler	+49 (0) 40 350 60 761
Lars Schwartzau	+49 (0) 40 350 60 450
Tim Storm	+49 (0) 40 350 60 415
Philipp Wiechmann	+49 (0) 40 350 60 346

EVENTS

LONDON

Natalie Meech	+44 (0) 20 3207 7831
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