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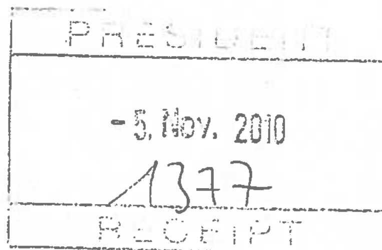

Mr Jean Claude Trichet
President
European Central Bank
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

4 November, 2010.

Dear President,

You will no doubt have noted the very adverse developments in the markets in recent days in relation to the widening spread of Irish Government bonds against the German bund. This issue gives rise to very serious concerns for the Irish Government particularly in relation to the potential impact on the credibility of the very significant budgetary adjustments which we have developed working closely with the European authorities. I know that this concern is one that is strongly shared by you.

The increase in spreads is of course underpinned by a variety of factors. International concerns regarding the budgetary and banking position in Ireland have for some months contributed to a situation where Irish spreads were consistently higher than those in most other Member States. As you know the Irish authorities are embarking on a significant continuation and intensification of our policy actions to achieve budgetary sustainability. It is absolutely vital that these endeavours are successful in order to secure fiscal and, indeed, overall financial stability in Ireland.

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However, it is very noticeable that over recent days the widening in spreads has accelerated on the basis of speculation on the conditions that may be necessary to apply to the debt of countries accessing the European Financial Stability Facility and reported policy comments of senior political figures. It is the case that many market commentators attribute these comments as being the primary driver of the increased spreads of peripheral countries, including Ireland, in recent days.

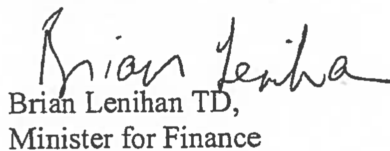
I fully appreciate that there are valid legitimate policy perspectives for individual Member States to hold and disclose but the reality is that already difficult market conditions are being worsened.

I am sure that you will agree that it imperative that comments particularly from senior political figures within the eurozone are consistent in their content and do not, as an unintended consequence, undermine the efforts of Member States such as Ireland to address the serious difficulties that they are continuing to confront.

I hope you agree with me on this matter and will continue to use your influence to help calm markets.

I enclose for reference some press commentary from recent days in both domestic and international media on this point as well as the latest details on the spreads of 10 year Government bonds in Ireland and other peripheral eurozone countries.

Yours sincerely,



Brian Lenihan TD,
Minister for Finance

3/11/10

By Paul Dobson

Nov. 3 (Bloomberg) -- German Chancellor Angela Merkel is once again provoking a selloff in the bonds of the region's most indebted nations.

After stalling European Union efforts to rescue Greece in the first four months of this year, Merkel yesterday stepped up her push to make bondholders pay toward any future bailout of a euro nation. Her proposal helped worsen a selloff in the bonds of the bloc's so-called peripheral nations. The extra yield that investors demand to hold Irish debt over German bunds rose to a record and the spreads on Greek and Portuguese debt widened.

"Merkel wants to reassure voters Germany won't underwrite the obligations of the rest of Europe," said Tom Sartain, a fund manager at London-based Schroders Plc, which has $245 billion under management and doesn't own Greek, Irish or Portuguese debt. "Talk of burden sharing is the opposite of what bond holders want to hear. The price action vindicates our decision not to hold these bonds."

Traders have dumped Irish and Portuguese bonds since EU leaders on Oct. 29 endorsed Merkel's push for a permanent debt-crisis mechanism, renewing speculation that those countries may follow Greece in seeking a bailout as they struggle to cut budget deficits.

The premium on Irish 10-year bonds over bunds rose 22 basis points to 484 basis points yesterday. Portugal's spread widened 13 basis points to 375 basis points and the Greek spread reached 833 basis points, the most in more than a month.

Trichet Warning

Merkel's push caused apprehension among some officials even before this week's selloff. European Central Bank President Jean-Claude Trichet told EU leaders he's concerned that talk of a debt restructuring mechanism would hurt the bonds of peripheral euro nations, according to an EU official familiar with the talks.

"I'm not surprised" that the proposal has "moved Greek and Irish spreads," said Toby Nangle, director of asset allocation at London-based Baring Asset Management, who helps oversee about $46 billion for clients and owned six-month Greek debt until last month. "These are movements toward private-sector burden-sharing and markets tend not to like that."

EU leaders have yet to agree on the shape of any new mechanism, which would replace the 750 billion-euro ($1.1 trillion) fund set up in May after it expires in 2013. EU leaders set a December deadline for the European Commission to sketch out how it might work, how to treat private bondholders and whether to involve the International Monetary Fund. Spain has already said that provisions to reschedule or cancel some debts would expose its bond to selling pressure.

Debt Reality

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BN Merkel Debt Plan Provokes Selloff Trichet Foresaw: Euro Credit
Nov 3 2010 0:01:00

"The more you talk about restructuring debt, the harder it is to obtain debt," Irish Finance Minister Brian Lenihan said in an interview with Dublin-based RTE television yesterday. "That is the reality."

Merkel's stance echoes her approach to Greece earlier this year when she initially refused to rush to its aid, sparking speculation about the euro region's ability to handle the worst crisis in its history. While billionaire George Soros at the time said her strategy risked pushing Greece into a "death circle," Merkel said the "tough" terms of the country's eventual bailout vindicated her policy.

The new push comes as her Christian Democrat party loses support to the Social Democrats, with an Oct. 27 Forsa poll putting the opposition 12 percentage points ahead of her CDU-Free Democrat government. The government also faces regional elections from March that involve 25 percent of the population.

Time Bomb?

Leaving taxpayers to shoulder the burden of bailouts may set off "a dangerous social time bomb" of popular dissatisfaction, Finance Minister Wolfgang Schaeuble said in a speech late yesterday. "The currency union was never designed as a model for the enrichment of financial speculators."

Merkel's government was the biggest contributor to April's Greek bailout and would also shoulder the lion's share of any rescue under the current temporary backstop.

"These things are more about politics than economics," said Paul Lambert, head of the global macro team at Polar Capital Holdings Plc in London. "It's clear that for some economies in Europe it's going to be incredibly difficult to make the fiscal adjustments needed on their own. It's either going to mean Germany picking up the tab, or countries in Europe being cut loose."

The German proposals are hurting Portuguese debt even after the nation's government and biggest opposition party reached an agreement Oct. 29 on next year's budget. The country's bonds are the third-worst performing government debt securities this year, down 5.7 percent, according to indexes compiled by Bloomberg and the European Federation of Financial Analysts Societies.

Irish Spread

Only Greece, with a 16 percent decline, and Ireland, with a 6.9 percent drop, fared worse. German bonds earned more than 8.2 percent this year.

The spread on Irish bonds has doubled in the past three months as the government tries to cut its deficit in the face of bank-bailout costs that may reach 50 billion euros. The country's 10-year bond yesterday yielded 7.304 percent, the most since 1996.

"The German government is following what the market is telling it," said Nicola Marinelli, a portfolio manager at

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Glendevon King Ltd. in London, which oversees $200 million in assts. "The Greek government, and probably the Irish and Portuguese, will need to be bailed out. If you sense that it's inevitable then it's better to have something to manage that than complete chaos."

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Independent.ie

Investors' fear sends yield on Irish bonds to new 7.45pc high

By Donal O'Donovan
Wednesday November 03 2010

The spiralling cost of Government borrowing hit a fresh high of 7.45pc yesterday as the European Central Bank (ECB) stepped in to calm the markets.

Germany's plan to get tough with bondholders, the failure to sell AIB's UK arm and fears that too much austerity could stifle the economy all added to the pressure on the bonds.

"The amount of selling has been relatively small, but the market is all sellers and no buyers, which drives up the yield. The ECB has come in to prevent this becoming a rout," said Padhraic Garvey, Head of Developed Markets Debt at ING Bank in Amsterdam.

Value

Yields of more than 7.4pc mean Irish 10-year bonds that pay 5pc in interest per year are being bought for a little more than 83pc of face value. Irish yields have now risen for six days in a row.

Bondholders have been selling Irish and other higher risk sovereign bonds since Germany proposed tough new bailout rules last week.

Under German Chancellor Angela Merkel's plan, lenders to sovereigns that are bailed out by the EU would take a haircut on their debt. If approved by EU members the proposals would come into force in 2013.

The EU needs a mechanism to manage defaults but holding discussions about the plan at a time when the market is so vulnerable has mystified many observers.

Yesterday Ms Merkel said that for rules to have have "more bite" to protect the euro, along with steps to prevent EU nations running up excessive debt, a crisis mechanism enshrined in the bloc's treaties is necessary for the longer term.

"We will set it up in such a way that European taxpayers will no longer be on the hook for possible new mistakes and turmoil on the financial markets," Ms Merkel said.

Fears that Ireland's austerity plans could hurt the economy are also turning some bondholders off Irish bonds. "With austerity measures you're damned if you do and damned if you don't. The market wants to see the cuts but at the same time fears they will hurt the economy," said Mr Garvey.

That adds to pressure on Finance Minister Brian Lenihan to produce a four-year plan that convinces investors who are now abandoning Irish debt to buy back in.

If the cuts he proposes are too deep, investors fear there will not be enough growth in the economy to revive the banks. If cuts are too shallow, investors won't believe the deficit can be brought under control.

The cost of insuring Irish bonds against default also hit a new high yesterday.

Credit Default Swaps (CDS) that insure bondholders against a default in the next five years cost 5.3pc early yesterday. This means a bondholder has to pay €530,000 to insure €10m of bonds against default. Bad news from AIB was one factor in the rising cost of insuring Irish bonds, which rose more sharply than Greek or Portuguese CDS, said Gavan Nolan, credit analyst at research firm Markit.

"The banking situation is an extra factor in Irish risk.

"On Tuesday Ireland underperformed the other peripherals after AIB said it could not sell its UK assets.

"That adds to the cost of the bank bailout for Ireland at a time when the sovereign debt market was already very nervy," Mr Nolan said.

- Donal O'Donovan

Financial Times

Debt costs jump for Dublin and Lisbon

By Richard Milne in London and Ralph Atkins in Frankfurt
Published: November 1 2010 19:41 | Last updated: November 1 2010 19:41

Borrowing costs for Ireland and Portugal shot up as investors took fright at European proposals to force them to take a greater share of losses in future state bail-outs.

The moves in the bond markets on Monday follow agreement at last week's European Union summit on a Franco-German proposal on a mechanism to resolve future Greek-style sovereign debt crises.

Ireland saw the premium it pays over German benchmark interest rates rise to 4.67 percentage points, while the yield on its 10-year bonds reached 7.14 per cent, up 0.22 percentage points. Both the premium and the yield set new records since the introduction of the euro.

Meanwhile, Portugal's yield rose 0.16 percentage points to 6.11 per cent, while Greece and Spain saw smaller rises and European banking shares fell sharply in a broadly flat market.

"People do seem shocked about the idea of a future eurozone debt restructuring – but this should not have been a surprise unless you really believed that the German taxpayer would always underwrite everything," said Erik Nielsen, Goldman Sachs European economist.

The rise in the yields of the so-called peripheral nations in the eurozone appears to fulfil the forecast of Jean-Claude Trichet, European Central Bank president, who warned European heads of state last week that the proposed rescue system would increase borrowing costs.

Gary Jenkins, head of fixed income at Evolution Securities, said the danger was that by talking about debt restructuring "it could become a self-fulfilling prophecy". Markets are particularly worried that borrowing costs for Ireland and Portugal could become so high that they are forced to tap the eurozone's bail-out fund, a potentially destabilising move.

Exacerbating the discord among Europe's leaders, a top ECB official on Monday sharply criticised Germany's plan to allow a debt rescheduling by a member state. "Calling for an orderly debt restructuring mechanism sounds nice and is costless. Designing and implementing it is somewhat different," Lorenzo Bini Smaghi, an ECB executive board member, said in a speech in Abu Dhabi.

Despite the soaring cost of borrowing – Greece's yields have risen by more than 1 percentage point in a week – the ECB made no purchases in its government bond-buying programme for the third week.

Separately, credit rating agency Moody's said Greece, Portugal and Ireland were likely to avoid sovereign bond defaults because of a strong domestic investor base of local banks and pension funds that would buy their government's debt even in times of stress.

Many investors, however, remain convinced that one or more countries, most likely Greece, will restructure. "You can't get away from the fact that there will be some kind of restructuring in the eurozone periphery," said Rod Davidson, head of fixed income at Alliance Trust Asset Management.

Additional reporting by David Oakley

Extracts from Embassy Summary of French Press Coverage

Paris Press summary, 3 November 2010

Foreign news stories, including the mid-term elections in the US, the Chinese State visit to France and continuing terrorist threats, make the headlines in Paris this morning.

1. Eurozone – Ireland

Le Figaro Economie reports on German Finance Minister Wolfgang Schaeuble's visit to Paris yesterday. "Eurozone: Berlin wants to make the private sector pay up; the German Finance Minister revealed.......his vision of the future mechanism for crisis resolution". The report describes Schaeuble as "an ardent defender of orthodoxy and a convinced partisan of tough measures to heal the ills of Euroland (sic)". Schaeuble set out his vision of the mechanism to resolve crises agreed last week by the European Council. The 27 agreed on the principles but gave themselves two months to work out the details, something that has not failed to cause concern on the markets. Unsurprisingly, Schaeuble defends a strict interpretation of the rescue mechanism. Besides financial sanctions, he is favourable to taking voting rights in the Council away from countries which are not respecting the budgetary discipline agreed by their peers. He calls for a restructuring mechanism for public debt involving private sector participation. "Countries in financial difficulties can't expect that the Community will assist them unconditionally..........Participation by the private sector should be a central element of the Mechanism". Schaeuble: "monetary union was never conceived as a means of enriching financial speculators; neither is it a system for financial transfers from the richer to the poorer countries". In the context of revising the Treaty, the report says that Berlin wants to attach to "the no bail out clause" – the English expression is used – a mechanism for restructuring which would not leave the holders of private bonds, notably banks and insurance companies, indemnified. Schaeuble apparently also availed of the opportunity offered by his visit to Paris to sing the praises of "the German economic model".

http://www.lefigaro.fr/conjoncture/2010/11/02/04016-20101102ARTFIG00659-zone-euro-berlin-veut-faire-payer-le-prive.php

A separate article in Le Figaro Economie is headed "Ireland, Portugal, Greece: costs of borrowing take off". The report says that Trichet's fears are being realised. Gilles Moec, an economist at Deutsche Bank, says "the market is thinking like Trichet: it hates uncertainty". Ireland's ten year bonds yesterday reached 7.22%, the highest level since it joined the Eurozone. "Even if Ireland and Portugal were already worrying the markets for the past two months because of their dangerous budgetary situation, investors were reacting in particular to the risk of debt restructuring in the countries of the Eurozone". Another article in Le Figaro reports on a study by Markit on growth rates in Europe. "The diagnosis is nuanced. It reveals in effect a Europe of different speeds, with important disparities depending on the particular country. Growth rates in manufacturing are improving in Germany, in Italy, in Spain, in the Netherlands, in Austria and in Ireland.

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Paris Press summary, 1st November

1. Outcome of European Council

On Saturday, Le Figaro's headline was "*Economic Governance: Merkel and Sarkozy relaunch Europe*". The report says that the 27 are agreed on " *a limited revision of the*

Lisbon Treaty"..........and "*Pandora's box risks being re-opened*". In a separate report on prospects for the EU budget, Le Figaro writes that "*Paris, Rome and Berlin had rejected the idea of suppressing direct aids to farmers in the framework of the CAP*". The editorial in Saturday's Figaro sees the Eurozone as going in the right direction but anticipates difficulties when it come to revising the Lisbon Treaty: "***it's hard to see the Irish — already quite suspicious — putting their heads on the block in ratifying a text of which they could be among the first victims***". Liberation (Jean Quatremer in Brussels) heads its report "*the 27 swallow the Deauville deal*" (i.e. the outcome of the recent Sarkozy-Merkel meeting). The report says that Merkel explained that she was forced by her country's Constitutional Court to insist on a revision of the Treaty. Le Parisien talks of re-opening Pandora's box.

Le Figaro Economie (Jacques Mével in Brussels) this morning says that ECB President Trichet is concerned about plans to revise the Lisbon Treaty and fears a negative reaction from the markets for sovereign debt. "*The devil is in the detail and after the agreement in principle arrived at with some difficulty in Brussels last Friday, the 27 are faced with a choice which is already causing division: what's the place of the law of the market in the new rescue mechanism for Eurozone countries threatened with bankruptcy?*". Merkel and Trichet are in opposing camps. What was agreed for Athens can't become the practice. Merkel's tough line was supported by France and Netherlands. Trichet's tough line caused surprise. What's the explanation? "*Announcing that restructuring is just around the corner could dissuade private investors, set off interest rates and **worsen the burden of countries like Greece and Ireland***". The report concludes "*just as the ECB is trying to disengage from buying up government bonds, Trichet's problems are increasing*".

SPREADS FOR PERIPHERALS

Spread	4.45pm	11.45am	10am	03-Nov	02-Nov	01-Nov	29-Oct	28-Oct	27-Oct
Greece	899	865	852	851	843	833	821	794	794
Portugal	434	416	411	396	386	372	348	345	340
Ireland	546	532	526	512	492	477	447	436	429
Spain	195	191	186	186	182	177	170	164	161
Italy	154	147	145	147	144	141	136	133	133
Bund yield	238	248	248	243	247	248	253	257	257