

MARKET INSIGHTS

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Eurozone crisis: The latest developments



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Introduction

The eurozone summit in late July was meant to bring an end to the peripheral debt crisis and stop contagion from spreading to Spain and Italy. The package of measures announced at the summit, including a further EUR 140 billion in aid for Greece and enhanced powers for the European Financial Stability Facility (Europe's bailout fund), were initially greeted positively by investors. However, renewed market instability at the beginning of August reflects concerns that the package does not go far enough.

Stephen Macklow-Smith looks at why the summit has failed to calm markets and what can be done to stop the crisis spreading.

Summit agreement: comprehensive, but with gaps

The eurozone summit to come up with a comprehensive solution to the debt crisis delivered much of what had been hoped for:

- The European Financial Stability Facility (EFSF) will be able to buy sovereign bonds in the market.
- The interest rate being charged by the rescue packages has fallen, making the cost less onerous.
- The French seem to have partially got their wish for private participation in refinancing peripheral sovereign bonds, although it's not yet clear at this stage whether this will be enough to trigger a declaration of default by the ratings agencies, nor whether such a default would trigger payouts on credit default swaps.

However, there were notable shortfalls:

- The EFSF wasn't increased in size.
- There was no talk of a eurozone bank deposit insurance scheme.
- The mechanism for changing the scope of the EFSF will take at least a couple of months to be worked through, and national parliaments will have a chance to vote, which means that we can expect lots of mini crisis points as Italy and Spain struggle to fund themselves at sustainable rates in the market.

With the US downgrade and worries over the US economic recovery compounding the nervous mood, markets suffered heavy losses in the first days of August. Investors were concerned that Italy and Spain were being drawn deeper into the crisis, while uncertainty also persists over whether the eurozone agreement will lead to a Greek default.

Will Greece default?

Greece, according to the Financial Times, has engaged the services of American law firm Cleary Gottlieb, and specifically of Lee Buchheit, who advised Iceland, Uruguay and Argentina on debt restructuring, and who wrote a book last year about how Greece could reduce its debt load. In the book, he made the point that Greek law governs 90% of Greek bonds, so it would be possible for the government to change their terms and introduce coercive collective action clauses without consulting bondholders. This is not an inviting prospect.

A scenario undoubtedly under consideration behind the scenes is one of conditionality from the euro group – continued funds for Greece only get disbursed if Greece adheres strictly to the agenda to modernise its economy. In some ways, after all, the eurozone is not asking for the impossible: raise pension ages towards the eurozone average; pay public sector workers for 12 months a year rather than 13; collect taxes; sell some non-core government assets. If Greece is not willing to do this in return for support in paying its way, then the eurozone would be entitled to withdraw support. However, such a course of action would only make sense if enough funds were in place to put a firewall around other indebted peripheral nations, and the funds aren't there yet.

How likely is fiscal union?

Within the eurozone, the sovereign debt problems have led to a contraction in liquidity in the banking system – or, rather, to the emergence of a two-tier banking system, with peripheral banks finding it increasingly difficult to fund themselves, while for banks outside the periphery it is pretty much business as usual. The short-term solutions lie in the hands of the European Central Bank (ECB), which has already announced a return to six-month repos, and has begun purchases of Italian and Spanish debt, bringing yields back down. The ECB could also announce an increase in liquidity, and potentially also a eurozone deposit insurance scheme, which would alleviate the pressure on deposits in the periphery. These are clearly all steps on the road towards closer fiscal union.

However, the solutions so far proposed will not solve the problem of the debt overhang: more will need to happen, and this is the moment when Europe collectively will need to decide whether to accelerate the move towards fiscal union. European Union (EU) Commissioner Olli Rehn has said that he is to publish a paper later this year about the feasibility of issuing jointly guaranteed Eurobonds. President Sarkozy has referred to the EFSF and the European Stability Mechanism as an embryonic European Monetary Fund.

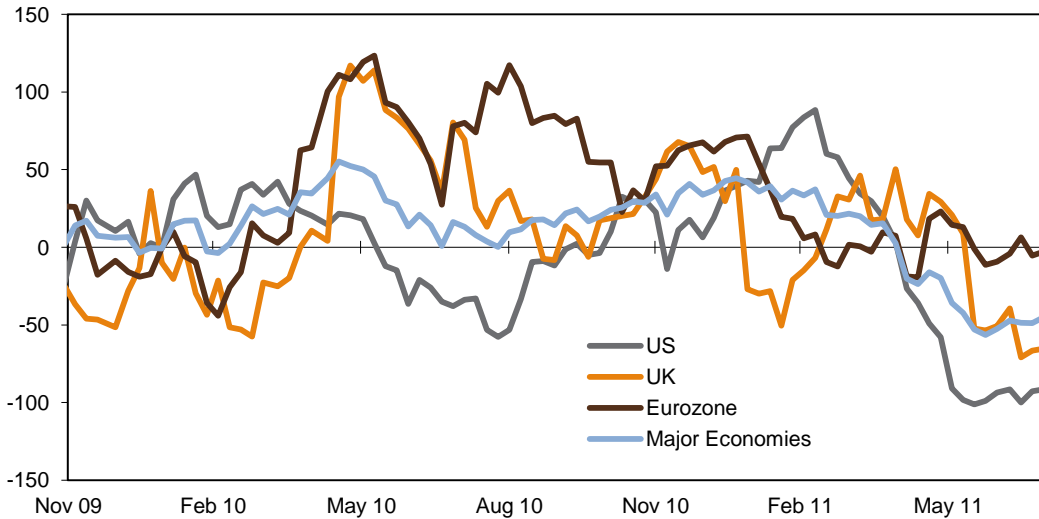
We have yet to hear from more sceptical voices, but this year's events may result in one important change in European affairs – namely that the European debate, hitherto dominated by the voice of politicians, may become dominated by the electorate. Over the last twenty years Euroscepticism has not been a mainstream voice in the European landscape (easily forgotten outside the eurozone, where it is mainstream), but there has been a modest rise in support for Eurosceptics in certain countries, although Eurosceptic parties currently tend to be right wing, and their Euroscepticism is masked by rather more vitriolic stances on other issues close to right-wing hearts. If progress toward fiscal union is to be derailed, voters are the most likely to do it.

In order to convince these sceptics of the need for closer fiscal union, it may be that a greater sense of crisis is necessary, in which case we may expect continued volatility in asset prices. An American senator speaking on a UBS conference call about US debt made the important observation that in politics you don't get recognition for sorting out crises before they happen – you get the plaudits for stepping in at the eleventh hour.

What is the effect of the recent weakness in economic data?

The overriding problem for the indebted Europeans is a lack of growth. The legacy of the credit boom and bust is a mountain of debt that somehow has to be overcome. There are only three ways to deal with debt: save it away, inflate it away, or default on it. For governments to reduce their debt by saving they need growth, and the second quarter undermined that prospect considerably.

Exhibit 1 – Citigroup economic surprise indices have turned down in recent months



Source: Bloomberg, data as of end-July 2011

GDP growth in the EU tends to be driven far more by exports than by consumption, so the slowdown in the second quarter has hit very hard. The Citigroup Economic Surprise Index (see Exhibit 1) illustrates the extent of the negative surprises in recent months.

Growth has been weak because higher commodity prices and inflation have squeezed consumption and driven monetary policy tightening. There has been plenty of comment on austerity undermining domestic growth, but for Europe the most important source of growth is exports to the emerging world. The rise in commodity prices earlier this year, which acted as a tax on real incomes as well as causing rises in emerging market inflation, was therefore a very significant catalyst in reducing demand for European goods. However, there is a ray of hope: with commodity prices falling (the S&P agricultural commodity price index is down 14% since March), the pressure on real income and emerging market inflation has reduced, which means we could see a growth recovery in the second half. As the chart shows, in the last three weeks the news has improved modestly relative to expectations.

A recent IMF paper on age-related spending makes it clear that the eurozone periphery is not the only area that needs to address excessive levels of government liability, both on and off balance sheet. In addition, beside government debt there are countries with excessive levels of consumer debt, non-financial corporate debt and financials debt, and

in most countries a combination of the four. This is why our fixed income team talk about the global economy experiencing a 'muddle-through' scenario for the next few years, with trend growth a good outcome.

What are the repercussions for European equities?

The European corporate sector remains, by and large, in excellent health. Companies have strong balance sheets and are cash generative, and the results season is improving as it progresses, with the current run-rate roughly in line with consensus. The decline in stock prices means that valuations are supportive both in the short and the long term. The equity risk premium is at elevated levels, especially given the recent rally in bonds, although this begs the question of whether equity prices are telling us that bonds at current levels are overvalued. Sentiment has clearly pulled back a long way, but this means that a great deal is already embedded in prices. A realistic ECB liquidity injection, and a recovery in growth, could catch the bears out.

For the moment, we are closely watching indicators of the strength of banking liquidity. On balance the situation has not tipped into systemic risk, but we will be monitoring events carefully to make sure that the authorities continue to move in the right direction.

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