EUROPEAN ECONOMICS FOCUS

April 5th. 2011

Debating the future of the euro

A scorecard for the March 24th-25th Summit

- An agreement was reached for a permanent " rescue mechanism" to be introduced in 2013, but due to the reneging of the German to put up money it has pledged, proper funding was lacking.
- The situation of Greece, Ireland and Portugal, the zone's most troubled economies is getting worse with the blame falling squarely on Europe's leaders.
- ✓ Portugal's credit rating was slashed to near-junk status on March 29th, while ten-year bond yields have risen above 8% as investors fear Portugal will have to turn to the European Union and the IMF for loans.
- ✓ The economies of both Greece and Ireland, Europe's two "rescued" countries, are shrinking faster than expected, and bond yields, at almost 13% for Greece and over 10% for Ireland, remain stubbornly high.
- Investors' fear that the rescues will not work are justified:
- ✓ The outlook of Greece, Ireland and Portugal economies are on an unsustainable course and darkening in large part because of mistakes made in Brussels, Frankfurt and Berlin.
- ✓ The EU's insistence that the peripherals' priority should be to slash their budget deficits by adopting more stringent austerity measures is raising their debt to GDP ratio, and dooming their growth prospects.

The European Central Bank in Frankfurt seems set on raising interest rates on April 7th, which will strengthen the euro and further undermine the peripherals' efforts to become more competitive.

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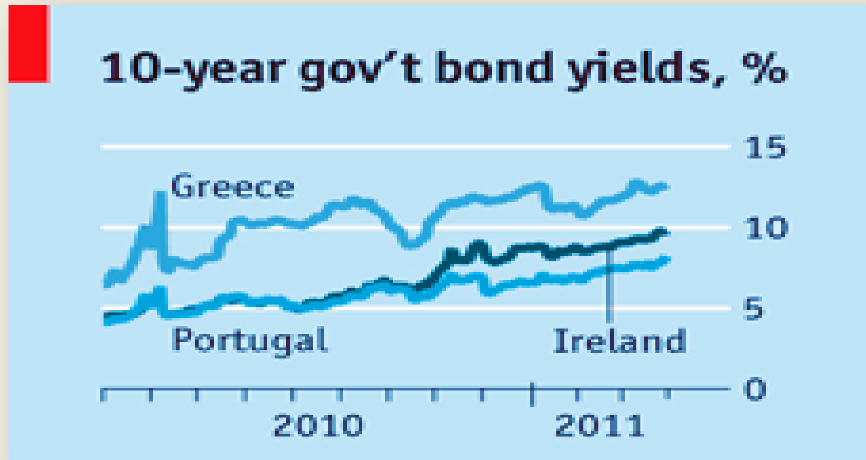


Ireland

- The country's debt burden was "sustainable" despite the government's commitment to support the latest bank recapitalisation.
- The €24bn the banks have been told to raise to provide an additional capital buffer will not add very much to the imposition on the taxpayer.
- Ireland's bank bail out has already cost €46bn. If the state ends up funding this latest recapitalisation, it would lift the bill to €70bn or more than 40 per cent of 2009 Gross Domestic Product.
- The country's debt to GDP ratio is set to rise to111 per cent by 2013 before falling to 109 per cent in 2014, according to figures this week.
- The €24bn, only €7bn to €8bn would end up being borrowed from the fund provided by the European Union and International Monetary Fund.
- In addition to the amounts already put aside, the banks were expected to raise an extra €5 to €6bn by imposing losses on subordinated bondholders: the quantum of debt doesn't increase very much. The servicing of it will be an interest charge of about 5.8 per cent on €7-€8bn. So it doesn't drive us towards unsustainability.
- The view within the Irish policymaking circle is that given the twin facts that the size of the recapitalisation was astronomical compared with any other banking crisis and that banks'credibility is so low, banks have to be loaded with capital beyond what would be normal simply to restore credibility.
- The government's decision to drop its election pledge that senior bondholders also be made to take losses on their investments was based on the rational that any attempt to impose losses on senior bondholders at Bank of Ireland and Allied Irish Banks would inhibit their capacity to get funds in the market in future.
- The Standard & Poor's decision to cut Ireland's credit rating to BBB+ was a mere reflection of concerns over decisions on resolving the eurozone debt crisis at last month's European Council meeting which were detrimental to the commercial creditors of EU sovereign borrowers.

More please

Irish banks' capital requirements
2011-13, €bn

	Allied Irish Banks	Bank of Ireland	EBS Building Society	Irish Life & Permanent	Total
Pre-buffer capital requirement	10.5	3.7	1.2	3.3	18.7
Additional capital buffer (imposed by the central bank):					
equity	1.4	0.5	0.1	0.3	2.3
contingent capital	1.4	1.0	0.2	0.4	3.0
Total capital required	13.3	5.2	1.5	4.0	24.0

Source: Central Bank of Ireland

Stress Test Results

Table 1: Central Bank 2011-2013 projected losses derived from BlackRock and used for capital purposes (€m) - % of nominal portfolio loan balance

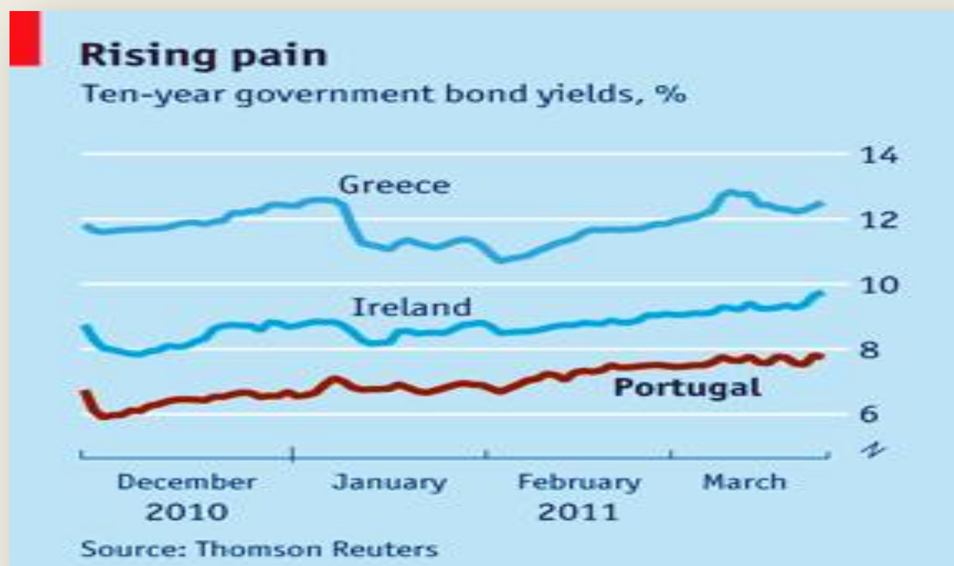
	AIB		BOI		ILP		EBS		Total	
Product	Base	Stress	Base	Stress	Base	Stress	Base	Stress	Base	Stress
Residential Mortgages	2,005 (6.5%)	3,066 (9.9%)	1,361 (2.3%)	2,366 (3.9%)	1,624 (4.8%)	2,679 (7.9%)	848 (5.3%)	1,380 (8.7%)	5,838 (4.1%)	9,491 (6.7%)
Corporate	564 (2.7%)	972 (4.7%)	799 (3.5%)	1,179 (5.2%)	0 (0%)	0 (0%)	0 (0%)	0 (0%)	1,362 (3.1%)	2,151 (4.9%)
SME	2,157 (11.2%)	2,674 (13.9%)	1,445 (8.4%)	1,837 (10.6%)	0 (0%)	0 (0%)	0 (0%)	0 (0%)	3,603 (9.9%)	4,511 (12.3%)
CRE	3,653 (21.3%)	4,490 (26.2%)	3,148 (15.4%)	3,847 (18.8%)	231 (11.3%)	400 (19.5%)	127 (15.1%)	197 (23.4%)	7,159 (17.7%)	8,934 (22.1%)
Non-mortgage Consumer and Other	1,167 (20.8%)	1,403 (25%)	627 (11.5%)	891 (16.4%)	259 (15.6%)	342 (20.7%)	0 (0%)	0 (0%)	2,052 (16.1%)	2,635 (20.7%)
Total	9,545 (10.2%)	12,604 (13.4%)	7,380 (5.9%)	10,119 (8%)	2,114 (5.6%)	3,421 (9.1%)	975 (5.8%)	1,577 (9.4%)	20,014 (7.3%)	27,722 (10.1%)

Portugal

A resignation that will likely lead to the next euro-zone bail-out

- The parliamentary defeat of the minority socialist government triggered by a vote on the fourth austerity package measures that include a special tax of as much as 10% on pensions above €1,500 a month, is creating a political vacuum with nobody having enough authority to negotiate a bail-out.
- This political crisis has increased the odds that Portugal will very soon seek help from the European Financial Stability Facility (EFSF).
- Portugal is between a rock and hard place: a failure to pass the austerity measures would create additional difficulties that will inevitably lead Portugal to seek an IMF/EU fund resulting in even harsher measures than those that failed to pass through parliament.
- There is a proposal to solve this political gridlock by forming a technical cabinet that would be better placed to negotiate a bail-out. But, the Irish experience will probably deter other European countries from cutting a deal with a government that now lacks the clear backing of its parliament.

- Despite the skyrocketing of Portugal's bond yields, budget deficit is lower than in most other troubled euro-zone economies. The country's most serious challenge, is to avoid "another lost decade" of low growth.
- The main challenge for Portugal is to overcome its deep-seated structural problems that have held the economy back for almost a decade, by initiating ambitious reforms.
- A decision by EU leaders to bail-out Portugal not only will require the use of a big chunk of the fund, but will likely swiftly move the market to attack Spain.



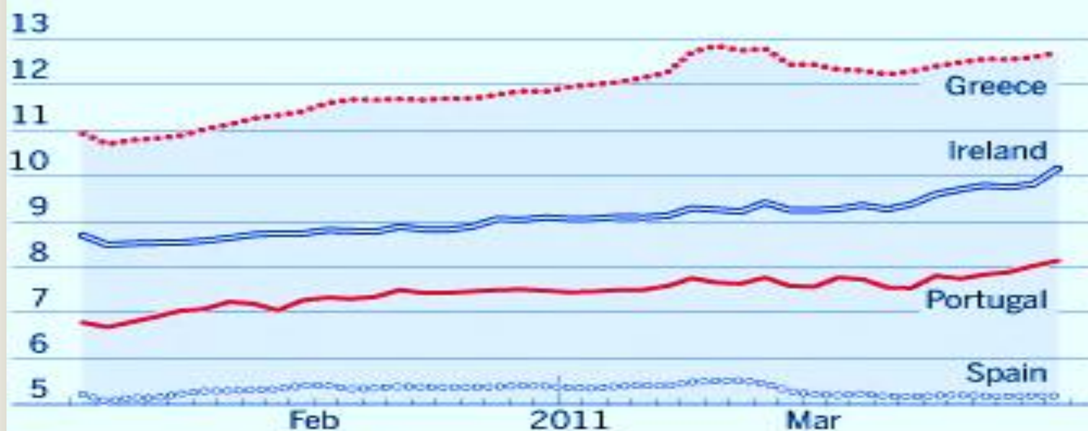
Assessing The Bond Market Reaction

Weariness all around and expectations for significant ramifications

- The agreement to create a legal route to default from 2013 at last week's European Union summit has sent Greek, Irish and Portuguese yields sharply higher and reduced what little volumes there were in these markets to a trickle.
- All eurozone government bonds from July 2013 will have collective action clauses, or Cacs, written into them, which will outline a framework for default and give a majority of creditors, probably about 70 per cent, the chance to trigger a restructuring.
- The crucial agreement to force private investors to share the burden of defaults is critically giving ESM senior creditor status over fund managers, meaning private investors will be last in the queue for the recovery of money. This new dynamic has made peripheral bonds less appealing to investors by focusing their minds on defaults.
- Fund managers are refusing to buy existing peripheral bonds for fear that they may suffer similar haircuts to those issued after 2013.
- The Eurozone agreed framework for a restructuring that has dispensed with the pledge that a default would be avoided at all costs, has rendered the EM logic that collective action clauses are a good thing because they tend to reduce yields as they offer creditors a collective force and prevent a small minority of so-called hold-outs blocking a default ineffective in the eurozone.
- With the exception of investors desirous of losing money, no investor believes a return to the peripheral bond markets is feasible until after these economies are seriously restructured.
- The problems of the peripheral markets are nothing to do with Cacs. Spain and Italy have not been affected because investors do not believe they will default. It is all about the deficit and the public debt and whether a country is likely to default.

Peripheral eurozone bond yields and costs of insuring against default jump higher, but Spanish sentiment improves

10-year government bond yields (%)



Five-year CDS spreads (basis points)

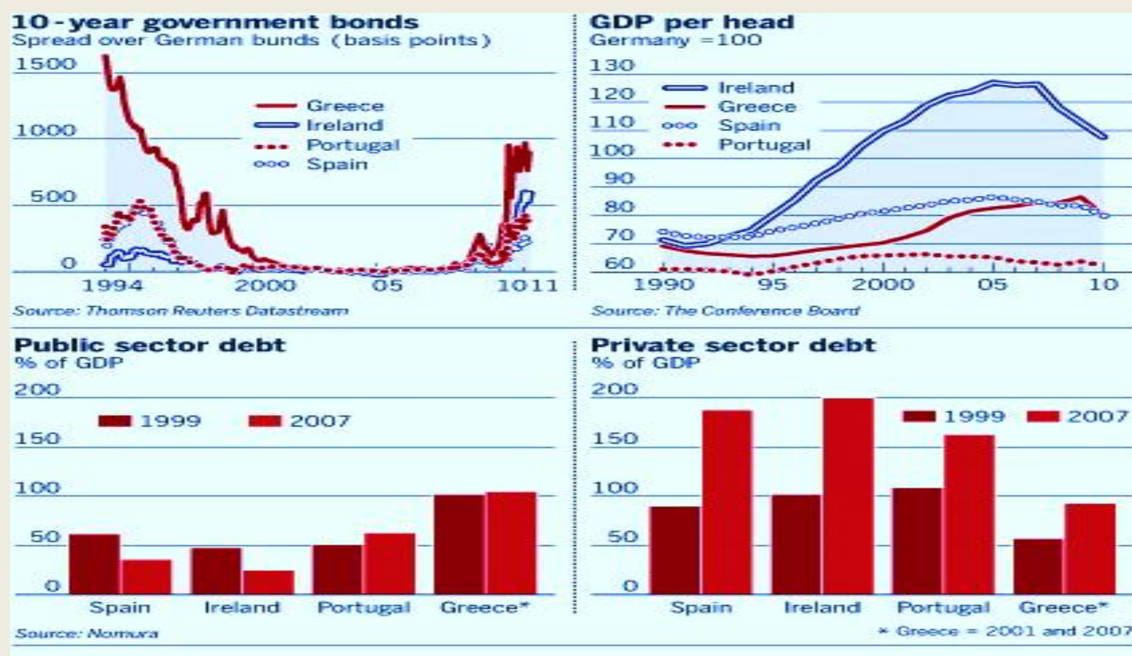
Sources: Thomson Reuters Datastream; Markit

Hedging Your Bets: Will The Euro survive?

Don't take YES for an answer. Expect turbulence

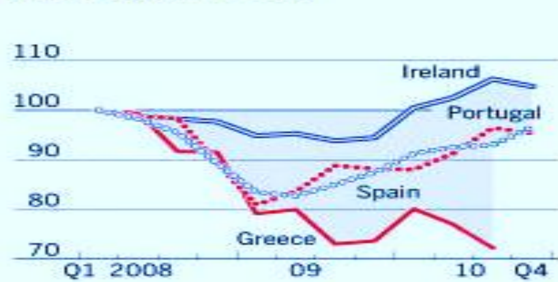
- **Three arguments backed by the premise that economic integration would create powerful interests for its perpetuation are in favor of survival:** first, the eurozone is backed by a profound political commitment; second, the long-term interests of participating countries are behind it; and, finally, the members can afford it. In short, the eurozone has the will and the wherewithal to keep the euro experiment afloat.
- **Only in extreme circumstances would European leaders contemplate a partial break-up of the eurozone**. Despite the Germans' anger over the sloppy behaviour of certain partners, the country's elite remains aware of both the perils of isolation and the benefits of the stability that the European project has brought to their country in its relations with all its neighbours.
- **This does not mean that some form of break-up is inconceivable:** Germany would exit if the body politic concluded that membership was incompatible with monetary stability; peripheral countries would also exit if they concluded that membership was incompatible with prosperity. Neither is close to that decision, as yet. Debt restructurings are quite likely, any sort of break-up much less so.

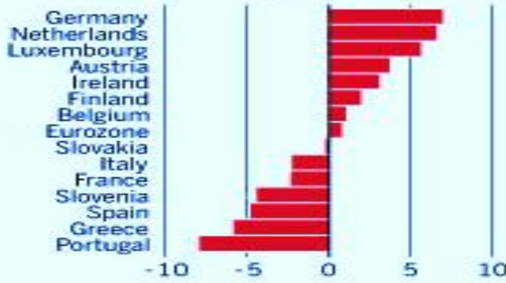
- **The manageability of public debt will depend on three things**: the primary fiscal deficit; the "snowball" – the relationship between the interest rate and prospective growth; and the impact on public debt of "stock-flow" adjustments – the need to bail out banks or "debt deflation" (jumps in the burden of debt due to falling domestic prices or currency devaluations, when debt is denominated in foreign currency). It is in the nature of crises that they make all three of these far worse.
- **In the near-term the eurozone must achieve three aims**: halt the banking and fiscal panics; help countries in difficulty regain economic health; and create a regime able to prevent such crises in future.

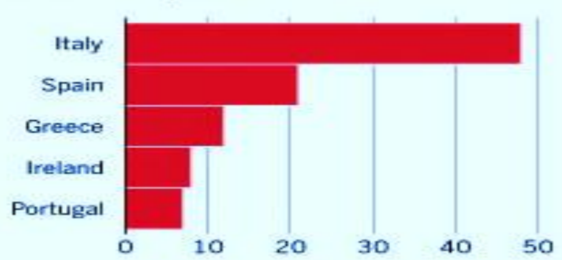


Enter The 'grand bargain' and a zest of pragmatism

- **The crisis has induced EU leaders to innovate Spectacularly** Europe is evolving, growing, continuing on its path of integration. This is not happening, however, according to some pre-defined, agreed plan, but rather in response to the challenges it faces, which in some cases are likely to endanger the very existence of the Union.
- **The response to the crisis included an array of risks and rewards that has pushed leaders to innovated spectacularly.** Within a year, they have approved a €110bn ($155bn) rescue package for Greece, in co-operation with the International Monetary Fund, endowed a new European financial stability facility with €440bn, decided to amend the treaty, to create a permanent rescue mechanism, amended the stability and growth pact, to enhance fiscal discipline, and created a new system of macroeconomic surveillance.
- **There are three challenges confronting the Eurozone.** First, is the unwillingness to recognise in the plans for economic co-ordination the link between the external surpluses of core countries and the financial fragility in the periphery. The focus remains overwhelmingly on fiscal indiscipline, which was not the cause of the crises in Ireland or Spain. Second, is the degree of the manageable cost that countries now in difficulty will have to pay to escape from their crises. The countries in difficulty have large structural primary fiscal deficits and their access to the financial market remains prohibitively expensive. Debt restructuring alone will not help those countries to adjust their way out of the mess. Further political and economic shocks are all too likely. The third challenge is caused by the failure to cut the Gordian knot connecting the fiscal to the financial crises. This policy failure is leading to loading the costs of past bad lending onto the taxpayers of countries whose private sectors borrowed excessively.







Sources: Thomson Reuters Datastream; OECD Economic Outlook; Nomura