

Contagion Risk From Europe's Crisis

Executive Summary

- Recent reforms in Europe regarding the peripheral debt crisis can be broadly classified into three main categories addressing Greek solvency, contagion risk and longer-term structural weaknesses.
- These reforms should help dampen the frequency of systemic stress points in which peripheral sovereign yields soar, global risk asset prices plunge and portfolio diversification becomes difficult to achieve. However, these measures do not go far enough.
- We don't believe that Europe's crisis, now entering its 20th month, is near a conclusion. We expect more systemic stress points—such as the one that reached a crescendo during mid-July—in which policymakers will be forced to confront their future head-on.

In what seemed like a replay of the dynamic that ultimately forced Greece, Ireland and Portugal out of private capital markets, investors began pushing yields on Spanish and Italian debt toward unsustainably high levels beginning in mid-June. Reacting to rumours that he could be forced out of the government, Italy's finance minister, Giulio Tremonti, declared, "If I fall, then Italy falls. If Italy falls, so falls the euro." While the first link in his chain of causation is suspect, the last is not. Spain and Italy are both too big to fail yet too big to rescue, and Europe's monetary union would not survive a disorderly default by either nation. Once again, the global economy seemed perilously close to the edge of the precipice.

There was a strong element of self-fulfilling, speculative behaviour in the recent episode. The higher yields rose, the more likely Spain and Italy were to default, thus justifying even higher yields in a vicious cycle. This was the sovereign equivalent of a bank run, where each successive deposit withdrawal further incentivises subsequent deposit withdrawals; liquidity becomes detrimental for solvency—first for the individual, then for the system as a whole. To be clear, poor fundamentals beget this dynamic. Still, there is little the sovereign can do unilaterally to wrest control back from the market.

Fortunately, the Italian cabinet responded with the passage of an aggressive fiscal austerity package, and the European Council agreed upon an impressive set of measures to strengthen the architecture of the monetary union. Policymakers were able to agree to just enough measures to calm markets on this occasion, buying time and returning the European crisis to its status quo of "kicking the can down the road." Risk assets rallied in relief, Spanish and Italian yields plunged, and the euro strengthened. However, we don't believe Europe's crisis, now entering its 20th month, is near a conclusion. We expect more systemic stress points—such as the one that reached a crescendo during mid-July—in which policymakers will be forced to confront their future head-on.

Genuine Progress

The recent reforms can be broadly classified into three main categories addressing Greek solvency, contagion risk and longer-term structural weaknesses.

Greek Solvency

- Greece received a second bailout package totaling €159 billion, comprised of €109 billion in official funds from the EU/International Monetary Fund (IMF) and an estimated €50 billion from private sector involvement (PSI). This should cover Greece's gross funding needs through at least mid-2014, and beyond, if the Greek government's privatisation program is successful.
- Lending rates will be reduced to 3.5%, a cut of about 100 basis points (bps) from the 4.5% rate on current loans. Loan maturities will be extended from the current 7.5 years to at least 15 years and up to 30 years, with a 10-year grace period on interest payments.
- PSI will extend beyond the estimated €50 billion through 2014, totaling €105 billion through 2019. The Institute of International Finance (IIF) estimates that participating banks, holding a combined €135 billion of Greek debt on their books, will select from a menu of four options,

each with its own accounting treatment. This will trigger a selective default from the rating agencies but not a credit default swap (CDS) event.

- In combination, these measures should significantly improve Greece's debt trajectory. Greece's debt (as a percentage of GDP) could be close to 110%, instead of 135%, by 2019.
- The lower rate and maturity extension will apply to Ireland and Portugal. This could lead to a 5% drop in Ireland's and Portugal's debt ratios by 2019, to 105% and 90%, respectively.

Contagion Risk

- The European Financial Stability Facility (EFSF) can buy bonds in the secondary market if the European Central Bank (ECB) judges that "exceptional financial market circumstances" pose a risk to systemic stability. The ECB requested this measure, which Germany opposed until recently. The measure must be ratified by individual member states before it becomes operational—a major point of uncertainty.
- The EFSF will be able to extend credit lines preemptively to non-program countries, such as Spain, Italy and any other country that becomes subject to funding strains in the private sector.
- EFSF funds can be used to recapitalise sovereign banking systems. This should help Spain in particular, which continues to struggle with its ailing cajas, or regional savings banks.

Structural Weaknesses

- A task force will be created to work with Greek authorities in an effort to improve GDP growth by directing EU structural funds.
- There was a commitment by all member states, except those under an official lending program, to bring down government budget deficits to less than 3% by 2013 at the latest. The Italian fiscal austerity package conforms to this principle, bringing the budget deficit below 3% by 2012 and into balance by 2014.
- There was a commitment to reduce the reliance on external rating agencies.
- There was a strengthening of the macroeconomic surveillance arm of the Stability and Growth Pact.

Preventing Systemic Stress Points in Europe's Crisis

The reforms aimed at dampening contagion risk are, by far, the most important. If fiscal union is the ultimate key to a stabilised European Monetary Union, the increased scope of the EFSF may be considered another baby step in that direction. These reforms should help dampen the frequency of systemic stress points in which peripheral sovereign yields soar, global risk asset prices plunge and portfolio diversification becomes difficult to achieve.

However, these measures do not go far enough. We would have liked to see the EFSF's lending capacity expanded from the current €440 billion. As it stands, the EFSF is too small to deter renewed market pressure. About €350 billion of funds would remain available after programs for Greece, Ireland and Portugal are taken into account. Considering that Spain and Italy must issue nearly twice that amount in the next 12 months in order to meet principal and coupon redemptions and to cover new borrowing, the firepower of the EFSF is clearly inadequate. Policymakers failed to construct a firewall for contagion risk, and therefore the door remains open to another bout of self-fulfilling speculative attacks with systemic implications.

Instead, the two too-big-to-fail countries—Spain and Italy—will have to become firewalls themselves. This can only occur once there is a clear downward trajectory in both countries' debt levels; this is still a number of years away. Consider a stylised sovereign budget constraint, where debt is expressed as a percentage of GDP:

$$\text{Change in Debt} = \underbrace{\text{Primary Budget Deficit}^*}_{\text{A}} + \underbrace{\text{Existing Stock of Debt}}_{\text{B}} \times \underbrace{(\text{Average Nominal Borrowing Costs} - \text{Nominal GDP Growth})}_{\text{C} - \text{D}}$$

*excludes debt-servicing costs

The formula shows that debt increases as primary budget deficits (A) and average nominal borrowing costs (C) grow. It also shows that debt decreases as nominal GDP growth (D) increases. This dynamic becomes more sensitive as the stock of existing debt (B) increases. The qualification is that all the variables on the right-hand side of the equation are endogenous—they influence one another in poorly measured ways. For example, the primary budget balance (A) and nominal GDP growth (D) are most likely negatively correlated, but how strongly is anybody's guess.

The challenge facing Spain and Italy—and global asset markets, in general—is to engineer a downward debt trajectory strong enough so that yields become resistant to negative economic surprises. In other words, even if GDP growth came out below expectations or primary budget deficits failed to narrow as quickly as forecast, borrowing costs would not increase enough to derail the overall downtrend in the level of debt. At this point, we would consider Spain and Italy to be firewalls and systemic risk to have been removed, even without an enlarged EFSF.

Primary Deficits (A)

Italy is in good shape on this measure. It has already achieved a balanced primary budget and is on track to reach a primary budget surplus of roughly 5% by 2014. Spain is on course to achieve a primary budget deficit of about 5% by the end of this year, down from 10% in 2009. Under its current fiscal program, Spain is hoping to achieve a balanced primary budget by 2014.

Average Nominal Borrowing Costs (C)

It is important to keep in mind that current market pricing reflects marginal borrowing costs, not average borrowing costs. Average borrowing costs are far more stable. They will only increase if marginal borrowing costs are higher than the borrowing costs on maturing debt. Average borrowing costs are currently 3.7% in Spain and 4.1% in Italy. They are projected to increase very modestly in coming years despite soaring marginal borrowing costs. However, since borrowing costs are mostly market-determined, this is the point where sovereign self-determination becomes subjugated to speculative attack.

Nominal GDP Growth (D)

Real GDP in the next few years is projected to grow by 1.25%–1.75% annually in Italy and 1.5%–2% annually in Spain. Inflation is projected to be 2% in Italy and 1.5% in Spain, bringing projected nominal GDP growth to 3.25% in Spain and 3.5% in Italy. Note that this is currently lower than the average nominal borrowing costs, and so both countries must run primary budget surpluses in order to sustain current debt levels. We believe that these numbers are more likely to come in below, rather than above, expectations, as high debt burdens tend to crush economic dynamism.

Existing Stock of Debt (B)

The only reason Italy is being considered alongside Spain is that its debt level is already 120% of GDP, twice Spain's level of 60%. However, this provides only a partial picture. If the global financial crisis taught us anything, it's that a complete analysis requires consideration of private sector debt alongside public sector debt. After all, the public balance sheet remains the backstop, as always, to an over-levered household and financial sector. Moreover, the ability of the government to raise tax revenue depends partly on whether or not the private sector is deleveraging. Stated differently, the endogeneity of the sovereign budget constraint depends mostly on private

sector dynamism. Private sector debt in Spain is 223% of GDP against Italy's 129%. Taken together, total debt in Spain is 284% against Italy's 247%. While still the primary threat, Italy's 120% debt level is not so bad as it would appear upon first glance.

Overall Debt Trajectory

Plugging these base-case estimates into the budget constraint, Italy's debt should decline by about 1% per year until 2014, after which it should accelerate to a 4% annual decline. Spain's debt should continue to increase by about 3% per year, finally stabilising by 2014 at around 70% of GDP before beginning a gradual decline. It is possible, if not probable, that the actual debt trajectory for both countries is slightly less constructive than these back-of-the-envelope estimates are. In any event, we will closely monitor the ability and willingness of both countries to stick with fiscal austerity measures, particularly Spain.

Conclusion

Contagion risk remains the primary threat. This analysis shows that the market still has ample scope to mount an attack on the vulnerable European countries. All it would take to trigger such an attack is a negative surprise in the economic data, such as slower-than-expected GDP growth or fiscal slippage. Yields could potentially increase enough to kick off another self-fulfilling speculative attack. The EFSF would be too small to serve as deterrence in that scenario. The risk then shifts back to whether policymakers have the political will to enlarge the size of the EFSF, taking the next step toward fiscal union. The EFSF may need total financial firepower of €1.5–2 trillion, which would also probably mean a lower credit rating than AAA. Clearly, the political will for such an enlargement is not there at the moment. The question is: Would the political will materialise when policymakers come face to face with the catastrophic consequences of a disorderly default by Spain or Italy?

We continue to expect significant haircuts in Greece, Ireland and Portugal, but these will be postponed until systemic risk has been removed and the system is better equipped to handle such a default. The euro should remain vulnerable to depreciation pressure, and the road ahead should be marked with additional systemic stress points until a clear firewall has been established, either via an enlarged EFSF or a clear downward debt trajectory in both Spain and Italy. During these systemic stress points, portfolio diversification will be difficult to achieve, but there will also be opportunities to profit from active management.

In conclusion, the framework laid out in our recent white paper on the subject, *Europe in the Balance*, remains valid¹. Europe's monetary union suffers from fundamental flaws and remains vulnerable to breakdown until the following three criteria are satisfied: the establishment of a sufficiently sized fiscal union; structural reform in the peripheral countries and, equally important, in Germany, and the implementation of a common bank regulatory and supervisory framework. We are not hopeful on any of these fronts, and so Europe's crisis should continue to muddle along even absent the occasional systemic stress points.

¹ This white paper is available on Western Asset's website, www.westernasset.com

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