

EUROPEAN ECONOMICS FOCUS

18th Oct. 2011



Can the euro survive the sovereign debt crisis?

- **Policymakers' latest plans to tackle the euro-zone debt crisis are unlikely to address the region's fundamental problems and secure the future of the single currency.** We still doubt that the euro will survive the crisis in its current form.
- **Hopes that the euro-zone's debt crisis could be tackled by a combination of austerity and bail-outs have not been met.** Budget deficits in the troubled peripheral economies have fallen only modestly and debt levels remain eye-wateringly high.
- **Accordingly, it is now inevitable that at least some countries in the region will undertake some form of default.** A "haircut" of perhaps 50% to 70% is likely to be needed to make any real difference to Greece's fiscal health and other countries may need to take similar action.
- **Major sovereign defaults will have severe consequences, not least on the euro-zone's banks.** Recent estimates of the total amount needed to recapitalise the euro-zone's banks have tended to be around €200bn. But allowing for both haircuts of 50% on peripheral sovereign and some private sector losses would easily double that figure.
- **This prospect has encouraged the view that the only way forward for the euro-zone is a decisive step towards wholesale fiscal union.** But while talk of euro-zone wide bonds has recently been revived, it is unlikely that any such measures will come soon enough, and be big enough, to prevent at least some euro-zone countries from defaulting.
- **But while default would reduce those countries' debt levels, it would not address their fundamental lack of competitiveness.** To do that, they would also need to leave the single currency. Meanwhile, when Germany and the other core economies face up to the enormous costs that they might have to bear to keep the euro together, they may conclude that the macro-economic case for sustaining the single currency is far from crystal clear.
- We said over a year ago that the chances that the euro would emerge from the region's debt crisis in its current form had slipped below 50%. That was a controversial view back then. **But events since suggest that the euro's chances of survival have fallen further, perhaps considerably.**
- **In terms of how a break-up might look, the exit of Greece and perhaps other small economies is probably still the most likely scenario.** But the longer Greece and the others stay in, the greater the chances that Germany and the other core economies will start to reconsider their own position.

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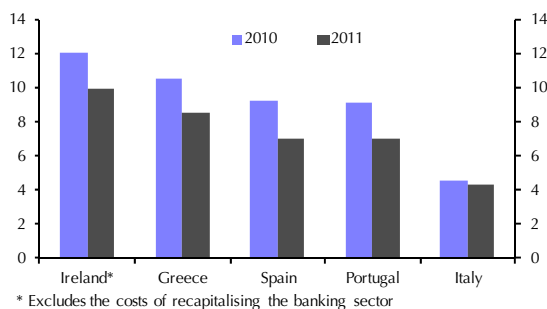
This Focus is an adapted version of a presentation given at the Capital Economics Conference held in Europe and North America in September and October 2011.

This *Focus* will examine how the euro-zone is trying to tackle its sovereign debt crisis and the implications for the future of the single currency. We will begin by looking at the costs of the problems in the southern and peripheral economies, before discussing whether the core economies are able and willing to bear those costs. We will then look briefly at the prospects of a move towards fiscal union, before concluding with our latest thoughts on the single currency's chances of survival.

Peripheral problems

We won't spend much time here on the peripheral economies' troubles, which are very well known. **Suffice it to say that the aggressive austerity programmes undertaken across the region are simply not working.** As Chart 1 shows, budget deficits may fall in some countries this year, but only modestly.

CHART 1: BUDGET DEFICITS (% OF GDP)

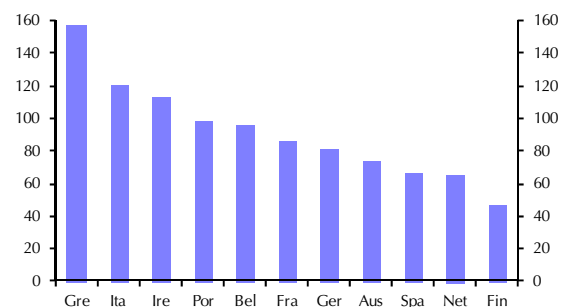


Sources – Thomson Datastream, Capital Economics

Meanwhile, levels of public debt remain eye-wateringly high and are still rising. (See Chart 2). The problem is that austerity does not work without growth. **And given the peripheral countries' deep-seated economic problems, debt**

reduction plans relying on solid rates of expansion never looked remotely plausible.

CHART 2: PUBLIC SECTOR DEBT (% OF GDP) 2011 FOR.

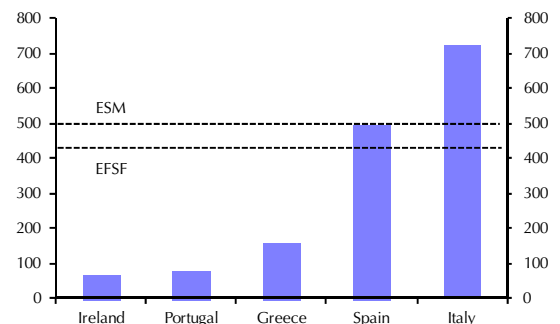


Source – Capital Economics

The policymakers have tried to buy those countries some time through bail-outs. The loan packages already provided to Greece, Ireland and Portugal - along with the impending second Greek package - are worth about €400bn, about two thirds of which comes from the EU.

But that's very unlikely to be the end of it. Ireland and Portugal seem likely to need further support, and there is a real and growing danger that Spain and Italy will too. As Chart 3 shows, in that scenario, the numbers start to get much larger. Meeting all five countries' financing needs until the end of 2014 would cost around €1.5trn.

CHART 3: GROSS GOVT. FINANCE NEEDS (€BN) (TO DEC. 2014)

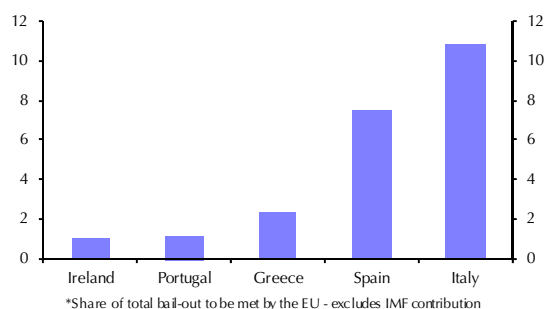


Sources – Bloomberg, Capital Economics

To cover that, the lending capacity of the current bail-out facility - the EFSF - would need to be roughly quadrupled. And the sums needed would be even larger if deeper recessions - or a need to pump money into banks - forced those governments to borrow even more.

Now there has recently been much talk of plans to increase - or at least leverage - the EFSF. But it's not clear what those will amount to. Chart 4 shows the peripheral economies' financing needs again, this time as a share of German and French GDP. It shows that if Spain and Italy need support, then the bill for Germany and France could breach 20% of their combined GDP. It's far from certain that they will be prepared to pick up that bill.

CHART 4: GROSS GOVERNMENT FINANCING NEEDS* (AS A % OF GERMAN AND FRENCH GDP) (UNTIL DEC. 2014)



Sources - Bloomberg, Capital Economics

Default now inevitable

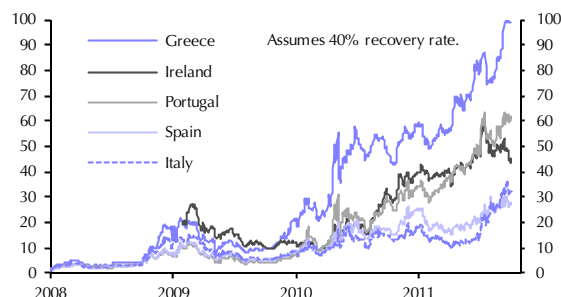
In any case, it has become very clear that the euro-zone debt crisis is not going to be solved by bail-outs alone. Accordingly, it now appears virtually certain that at least some countries will turn to one of the more radical solutions to deal with a fiscal crisis - default.

Indeed, the proposed second rescue package for Greece already includes plans for a mild form of default in the shape of a supposedly voluntary extension of bond maturities. This is expected to result in a reduction in net present value for bondholders - a so-called "haircut" - of about 21%. But that looks woefully insufficient. Given the size of Greece's debts and its economic outlook, haircuts of more like 50% or even 70%

might be needed to make any real difference to its fiscal health.

Again, there is talk that something like this is now being planned and the markets certainly appear to be anticipating something fairly dramatic. Chart 5 shows probabilities of default derived from credit default swaps. While you wouldn't want to interpret the figures too literally, they suggest that something like a 60% Greek haircut is almost guaranteed over the next five years.

CHART 5: PROBABILITY OF DEFAULT OVER 5 YRS (%) (DERIVED FROM SOV. CDS PREMIA)

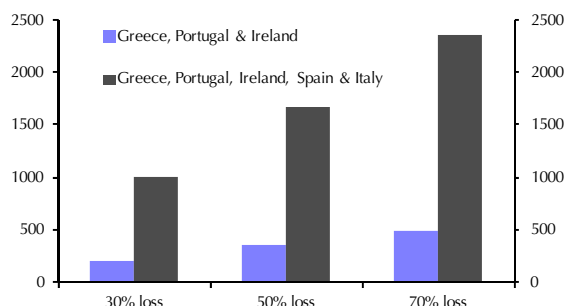


Source - Bloomberg

Now German Chancellor Angela Merkel has insisted that that couldn't happen until the proper arrangements are put in place in 2013. But that looks like another example of euro-zone policymakers failing to recognise the nature of the situation and running hopelessly behind events. Indeed, the former head of Argentina's central bank - who presumably knows about these sorts of things - recently advised Greece to "default soon, and default big".

Neither, alas, is this just about Greece. CDS markets also imply that Portugal and Ireland are likely to default in some manner, with a growing risk of the same in Italy and Spain. If so, the losses from sovereign defaults could be very sizeable. As Chart 6 shows, 50% haircuts in Greece, Ireland and Portugal would amount to something like €350bn, rising to €500bn for a 70% loss. But if the same also applied to Italy and Spain - the blue bars - the losses could rocket to €trn or above. That's 20% of euro-zone GDP.

CHART 6: POSSIBLE DIRECT LOSSES FROM DEFAULT (€BN)



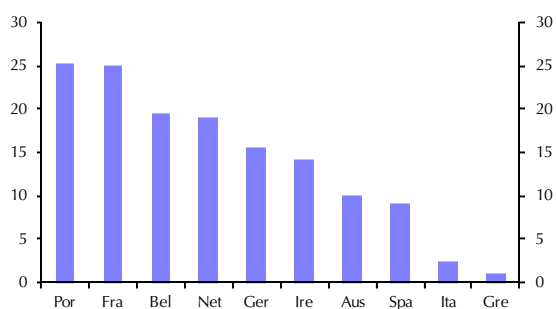
Source – Capital Economics

Needless to say, losses of that size could have major financial and economic consequences right across the euro-zone and beyond. But much attention has focused on the potential effects on the euro-zone’s banks.

Quantifying those effects is far from straightforward. Somewhat unhelpfully, this summer’s bank stress tests – just like last year’s – failed to incorporate the effects of a sovereign default into their calculations!

But Chart 7 gives us an idea of the risks by showing banks’ exposures to the peripheral and Southern economies by country, expressed as a share of GDP. Note that these figures include exposures both to sovereign debt and to private sector debt, on the basis that losses are also likely on the latter. They do not include banks’ exposures to their own economy.

CHART 7: BANKS’ EXPOSURES TO PERIPHERAL ECONOMIES (% OF GDP) (Q1 2011)

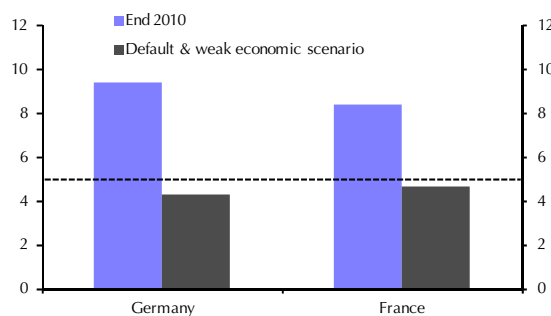


Source – Thomson Datastream

As you can see, French banks look particularly vulnerable due to their heavy exposure to other banks in the periphery. But alongside their Belgian and Dutch counterparts, German banks are also pretty heavily exposed.

Against that background, Chart 8 shows what might happen to German and French banks’ capital ratios in a scenario incorporating 50% haircuts on peripheral sovereign debt and 10% losses on private sector exposures.

CHART 8: BANKS’ CORE TIER 1 CAPITAL RATIOS (%)



Sources – EBS, BIS, Capital Economics

As you can see, those conditions would leave banks’ capital ratios below the 5% minimum specified in the bank stress tests, suggesting that the German and French Governments would have to pump large amounts of money into their banks.

The same would also apply to other countries. Indeed, recent estimates of the total amount needed to recapitalise the euro-zone’s banks have tended to be around €200bn. But allowing for both sovereign haircuts of 50% and private sector losses would more than double that figure.

And even this captures just one aspect of the potential damage to banks. Worries about their solvency would probably spark major deposit runs, and sources of wholesale funding would freeze up. (See *European Economics Focus* “How a banking crisis could sink the euro”. 18th Jul. 2011.)

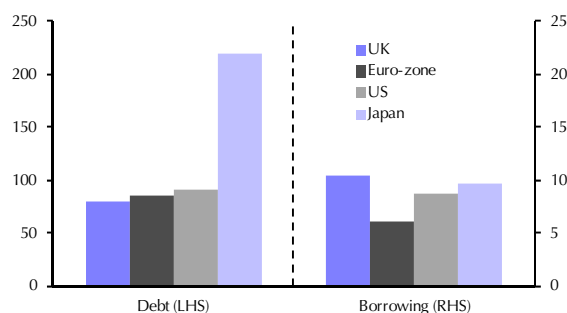
A move towards fiscal union?

The potential damage caused by large-scale defaults has encouraged a belief that the only way forward for the euro-zone is an organised move

towards wholesale fiscal union. The logic here is that, despite the periphery's problems, the euro-zone's aggregate fiscal position is not too bad.

As Chart 9 shows, the region's overall budget deficit is about 6% of GDP – on the RHS - and its level of debt is about 85% of GDP – on the LHS. Both actually compare pretty favourably with the equivalent figures for the UK, the US and Japan. **So if the burden were spread out more evenly, the problem would be at least partially resolved.**

CHART 9: INTERNATIONAL FISCAL INDICATORS (% OF GDP)



Source – Thomson Datastream

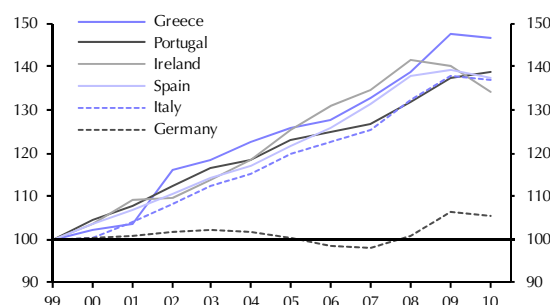
And hopes of a step in this direction have recently been revived by an EC announcement that plans for euro-zone-wide bonds will soon be advanced. In theory, these could reduce financing costs for peripheral economies substantially.

Still, with Germany strongly resisting the idea, it seems unlikely that euro-zone bonds - or indeed more substantial forms of fiscal transfers - will happen soon enough, and decisively enough, to prevent at least some euro-zone economies from defaulting on their debts.

Can the euro survive?

So what does all of this mean for the future of the euro itself? Well, one issue is whether the smaller economies will want to remain in the currency union. On its own, default would reduce their debt levels and ease their near-term financing pressures. But it would not address their fundamental lack of competitiveness, underlined in Chart 10 by the rise in their relative unit wage costs since they joined the euro.

CHART 10: UNIT WAGE COSTS (1999=100)



Source – OECD

Closing that gap within the euro-zone could take a decade or more of depression and deflation. **Given this, we have long argued that, to fully address their fiscal and economic problems, those countries would need both to default and to leave the single currency.**

Now that, of course, could cause those economies even more pain in the near-term as falling exchange rates magnify their foreign currency liabilities. But default - coupled with the prospect of renewed growth further ahead - would cushion that blow. **And should one small country leave, the likelihood of others following sooner or later would surely be very high.** Massive outflows of funds, crumbling banks and soaring bond yields could force them out very quickly. Or the sight of former members ultimately prospering outside the euro might persuade them to follow later on.

An equally pertinent question, though, is whether the core economies will judge that the costs of keeping the euro together are simply too high. After all, if the peripheral economies are going to default anyway, then the potential costs of letting them leave – or, indeed, throwing them out – are presumably reduced.

Making this judgement with any precision is impossible. And much depends on just what the alternative to the euro might be. Nonetheless, we can at least think about the sorts of things which Germany, say, might consider in deciding whether the euro is worth saving.

And with the help of some academic studies, conventional rules of thumb and a bit of reasoned judgement, we can come up with some very rough numbers, shown in Table 1. Note that these figures apply over a ten year period, which seems like a sensible time horizon over which to think about these sorts of things. But they are expressed as a share of one year's GDP.

TABLE 1: COSTS TO GERMANY OF KEEPING EURO TOGETHER VS. BREAK-UP (% OF GDP) (OVER 10 YRS)

Costs of keeping euro together	
Financing future peripheral borrowing	25
Higher German borrowing costs	5
Total	30
Costs of allowing euro to break up	
Bigger initial loss on peripheral debt	10
Transaction/hedging costs	5
Higher exchange rates	5
Looser fiscal policy	-5
Total	15

Source – Thomson Datastream

As we have described, keeping the euro-zone together would almost certainly require Germany to provide continued fiscal support to the peripheral economies, either via further defaults and bank recapitalisations or some form of fiscal union. If Germany had to shoulder, say, 40% of peripheral government borrowing over the ten years, this might add up to about 25% of annual German GDP. The likely higher level of German borrowing costs over the period might be worth another 5% of GDP.

On the other hand, allowing a break-up would presumably lead to bigger near-term losses on Germany's peripheral exposures, perhaps of around 10% of GDP – although long term losses might be reduced. And returning to a partial or fully floating currency could involve additional transaction and hedging costs of perhaps another

5% of GDP over 10 years, though we suspect that is an over-estimate.

Finally, Germany would presumably end up with a stronger exchange rate and hence lose some of its competitiveness. The adverse effect on its exports might cost it another 5% of GDP, although that would be much smaller if Germany remained in a core euro-zone with its Northern neighbours. Either way, it should be able to offset that by reflating its domestic economy through looser fiscal policy.

Now clearly we would not want to put very much emphasis on these sorts of estimates. And we wholly recognise that the issue is not solely an economic one. **Nonetheless, when Germany and the other core economies face up to the enormous costs that they might have to bear in order to keep the euro together, they may conclude that the macro-economic case for sustaining the single currency is far from crystal clear.**

Conclusions

To conclude, then, hopes that a combination of austerity and growth would solve the euro-zone's sovereign debt crisis have not been met. Major defaults now appear inevitable, severely testing the ability - and the conviction - of both the peripheral and core economies to keep the currency union together.

We said over a year ago that the chances that the euro would emerge from the region's debt crisis in its current form had slipped below 50%. That was a controversial view back then. But events since suggest that the euro's chances of survival have fallen further, perhaps considerably.

In terms of how a break-up might look, the exit of Greece and perhaps other small economies is probably still the most likely scenario. But the longer Greece and the others stay in, the greater the chances that Germany and some of the other core economies will start to reconsider their own position.