Global Counsel

The Eurozone's difficult year

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Summary

- The Eurozone enters 2012 badly weakened and with a number of key interrelated risks hanging over it. Greece remains the most fundamental, but the weakness of the European banking system, the deteriorating economic outlook and the French election all have to factored in as significant threats.

- The new Spanish and Italian governments have shifted sentiment with respect to the periphery. That sentiment remaining positive depends on the market believing the two countries positions can be assessed in isolation from a far-reaching change in the political structure of the Eurozone, which will not happen – yet.

- The new European Treaty will be broadly irrelevant to the resolution of the underlying crisis at best; at worst it will have wasted time and political capital. However, Germany is not as obstructionist as it is sometimes caricatured, and there are interesting institutional innovations taking place in Brussels.

- Baring a serious crisis, there will be no new 'grand bargain' on political and institutional Eurozone governance in 2012 – although we may see the outlines of one start to emerge. There is, however, a chance that the bloc will muddle through this minefield. The Eurozone's ability to survive 2012 will depend on a combination of public confidence, political leadership and a significant measure of good luck.

This Global Counsel Insight looks at the prospects for the Eurozone over the first half of 2012. In particular, it identifies events and problems that could trigger a deepening of the Eurozone crisis in 2012. These triggers are correlated and mutually reinforcing: none of them is likely to happen in isolation, and the incidence of any of them dramatically raises the risks attached to all of them.

The risks of the Eurozone facing a severe crisis in 2012 are high, but it is possible this will be avoided and the Eurozone will continue to muddle through. A combination of good luck, flickering economic confidence and political leadership will be required; however the Eurozone that survives to 2013 will still face considerable long term challenges. For the short term, success for the Eurozone in 2012 may simply be survival.

The new Fiscal Treaty

In Brussels the new treaty is seen as a distraction at best. It takes the useful step of requiring Member States to write fiscal sustainability rules into their own primary law (although no longer into their constitutions – a move aimed at avoiding a referendum in Ireland), but does little else that was not already covered by the EU's new economic governance legislation of September 2011 (the so-called 'Six Pack').

A combination of the desire to avoid difficult political ratification debates, lack of appetite for more radical change and desire to heal – at least on paper - the rift with the UK by integrating the new treaty into the full EU treaties within five years means that the treaty will be narrow and will focus exclusively on fiscal discipline. It will fall far short of the kind of 'grand bargain' that most supporters of the euro (and most of its critics) believe is necessary for its long term survival – collective debt liability, the ECB (or EFSF) acting as lender of the last resort and closer fiscal integration.

The new treaty is about coordination, not integration, at a time when most observers have concluded that more than coordination is needed to save the Eurozone. The new treaty might provide some further political cover for ECB intervention. But the markets are unlikely to see it as having moved the Eurozone further forward from the crisis of last Autumn: Standard and Poor's implied such a judgment in their downgrade statement in January. Having said that, enough of the draft treaty was leaked to ensure that expectations are pretty low. It has however, wasted important time and political capital.

The Greek problem

Greece remains the most pressing immediate problem for Eurozone governments. There is no credible alternative to a serious haircut on its outstanding debt – simply as a matter of arithmetic Greece's debts are now unpayable on any credible projection of growth or the Greek state's political ability to impose surplus budgets on its population for a decade or more. The key questions all relate to whether this can be managed without serious contagion risk.

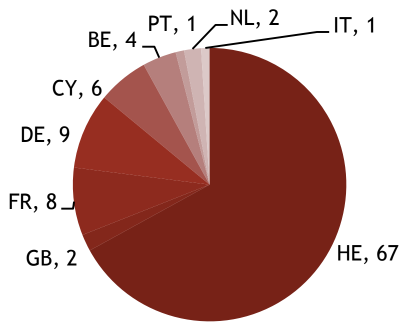

Chart 1: Exposure of European banks to Greek public debt (%of total)
Source: EBA 2011

Concretely, it will require a large new recapitalization of Greek banks – a significant tranche of the next slug of EU/IMF/ECB bailout money (assuming it is disbursed) will go straight into propping up the Greek banking system. For the further third of Greek sovereign debt that is held outside of Greece this implies a significant and unwelcome hit for banks in France, Germany and Cyprus (Chart 1). Inevitably, it will also shape market views of the likely outcome of Portugal's bailout process and recovery, although the fundamentals in the two states look very different.

While there are plenty of people in Brussels and Berlin who would like to see Greece exit the Eurozone, it is hard to see how this could be done in a managed way, at least in the short term. The redenomination of Greek external debt into a weaker drachma would be likely to produce a full default. The general view in Brussels is that the contagion effect – both on the banking system and on external sentiment regarding the periphery - from an exit would be uncontainable. Were the principle of recomposing the Eurozone to be accepted, the political cohesion of the bloc would be profoundly tested. If Berlin is willing to let Athens go, why not Lisbon? At this point, there is no political interest in even contemplating the question.

Stalling growth

Even assuming that the Greek problem can be contained for the time being, the fundamentals of the European economy now pose a problem for the Eurozone. The projected slide in growth rates in 2012 and 2013 as fiscal contraction bites and European corporates and households de-lever only makes the mountain of public and private debt look more daunting.
As Standard and Poor's noted in their January downgrade of all but the prospects for the German economy, the lack of growth in European economy is likely to become as much of a driver of market expectations as assessment of the scope of

austerity measures. If growth deteriorates significantly the risk of further sovereign downgrades in the first half of the year cannot be excluded. While downgrades may not translate perfectly to borrowing costs, Spain's loss of A-grade status or a further erosion in French ratings, both of which are not implausible, would be likely to have a serious impact on market sentiment.

Bank Failure

The obvious weakness of the Eurozone economy rests in its banking system and the extent to which it is now locked in a mutually destructive embrace with European sovereigns. With huge amounts of bank debt to be rolled over in 2012 and large parts of the banking system now heavily dependent on ECB repo life support, the sector looks exceptionally vulnerable.

The falling value of sovereign debt holdings, let alone significant write-downs on exposures to the periphery, impact not only balance sheets but on the need to provision or raise capital to maintain European Banking Authority capital requirements. The weaker banks, including some of the Spanish *caja* savings banks are unlikely to find market support and will have to seek to do this through the European Financial Stability Fund or its European Stability Mechanism successor.

A Spanish or Italian liquidity crisis

In Spain and Italy the new governments of Mariano Rajoy and Mario Monti have both made a concerted attempt to reassure markets with credible austerity programmes. Both have seen borrowing costs fall as markets have responded to the perception that Italy in particular has checked itself into the political equivalent of economic rehab. However, in both states the sustainability of austerity programmes is vulnerable both to the further deterioration of growth and to popular resentment. Monti's approval ratings still hover around 60%, but have fallen sharply as the detail of austerity plans has emerged.

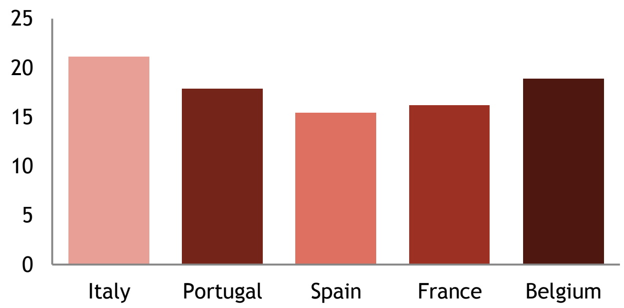

Chart 2: Estimated public debt issuance 2012 (% of GGDP)
Source: IMF 2011.

No less importantly, both Monti and Rajoy have made an implicit gamble that the market is willing or able to differentiate between their own economies and the long term institutional and political future of the Eurozone as a whole. Both Spain and Italy are scheduled to borrow large amounts in the course of 2012 (Chart 2), and Spanish and Italian borrowing costs are likely to reflect views of the political outlook for the Eurozone as much as Spanish and Italian fundamentals.

On balance, absent a serious change in external factors, Spain and Italy now appear able to manage their way out of the immediate liquidity crisis. However, a dramatic shift in sentiment could quickly put their borrowing costs back in play and a major failed Italian or Spanish bond auction in the first half of the year remains a nightmare scenario for Brussels and Berlin, not least because it would immediately push to the forefront the question of the scope of ECB intervention and trigger a tense and unwelcome bout of crisis summitry.

The French election

A potential wildcard in the Eurozone pack for 2012 is the French Presidential election in May. It remains very difficult to call. Sarkozy is weak and relatively unpopular, but Socialist challenger Francois Hollande has yet to articulate much of an economic or European strategy and has recently seen his poll lead eroded. There is a possibility of a strong showing by either the far right candidate Marie Le Pen or the perennial third party challenger Francois Bayrou disrupting the outcome.

France provides the markets with plenty of scope for believing French politicians will be distracted at a critical time and have an uncertain mandate. At best this could be a period of stasis at the top of the French system while it absorbs first the French Presidential election, then the Assembly elections a month later, and then a potential change in government. At worst it could mean a sharp populist shift in French politics towards rejection of the European consensus on the need for fiscal austerity, or anti-Europeanism, or both. Any of these will spook the bond markets to a greater or lesser degree.

And now for the good news

There is not a lot of good news. The best that can be said for the current situation is there remains some scope for a political strategy of muddling through to succeed. If Greek debtholders can agree a carefully managed haircut and the market views this as a self-contained necessity, then it is plausible that Greece can be placed in an unhealthy but not contagious state of wardship of the EU, the ECB and IMF, to be dealt with another day.

The new Spanish and Italian governments both have a margin of goodwill from the markets, at least while the wider political and economic environment remains free of the perception of immediate crisis. While both have to manage tough domestic politics, and the Spanish will have to manage a difficult process of bank debt write-downs and recapitalisations, neither of these is insurmountable.

While the ECB is not going to announce a policy of constraining Spanish and Italian debt costs by intervening in the secondary markets, it has already dramatically expanded its balance sheet to provide liquidity to the banking system and some support for Spain and Italy. Again, there is a clear extent to which Europe is storing up problems for another day, not least in the degree to which its central bank is now effectively subsidizing its banking sector. Nevertheless, *in extremis*, and with implicit German political acquiescence, the ECB has chosen to interpret its price stability mandate in a wildly sweeping way in order to put its balance sheet between the Eurozone and even deeper crisis. Mario Draghi may be regarded as more German than Italian, but he is no Bundesbank German.

Although the new European Treaty will in itself be largely irrelevant to this and future crises, other parts of the European machinery are quietly innovating in institutional design. The creation of the European Stability Mechanism in the middle of 2012 will mark a substantial departure for the Eurozone. Although this has gone largely unremarked, its structure will resemble that of the IMF. Although the precise way in which it will be able to impose contingent conditions on lending is still unclear, it will create a liquidity backstop for Eurozone states that has not existed in the past. Critically for the Germans, and unlike the ECB, its board will reflect economic weight, and – as a senior German official puts it: “the creditors will always outvote the debtors”.

If Eurozone states begin to come round in the course of 2012 to the idea of moving towards a system of collective debt liability such as Eurobonds then the political weather will genuinely have changed in an ‘intergrationist’ direction. *If it is credible*, this kind of medium term perspective would inevitably affect the market’s perception of long term debt costs and push down yields, much as a clear roadmap towards monetary union did after the collapse of the Exchange Rate Mechanism in the 1992. Even among the triple-AAA Eurozone sovereigns, some form of debt mutualisation is widely accepted at the level of Finance Ministries. But it remains a difficult political sell in Germany to put it mildly.

None of this is particularly optimistic. Even a good outcome will leave many of the toughest questions about the long term institutional and economic sustainability of the Eurozone unanswered. But given the fact that the collapse of the Eurozone is now a plausible possibility, a Eurozone that limps into 2013 out of immediate danger and with a developing sense of the scale of the political challenges ahead will probably feel like success.

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