Western Asset

The Eurozone Crisis

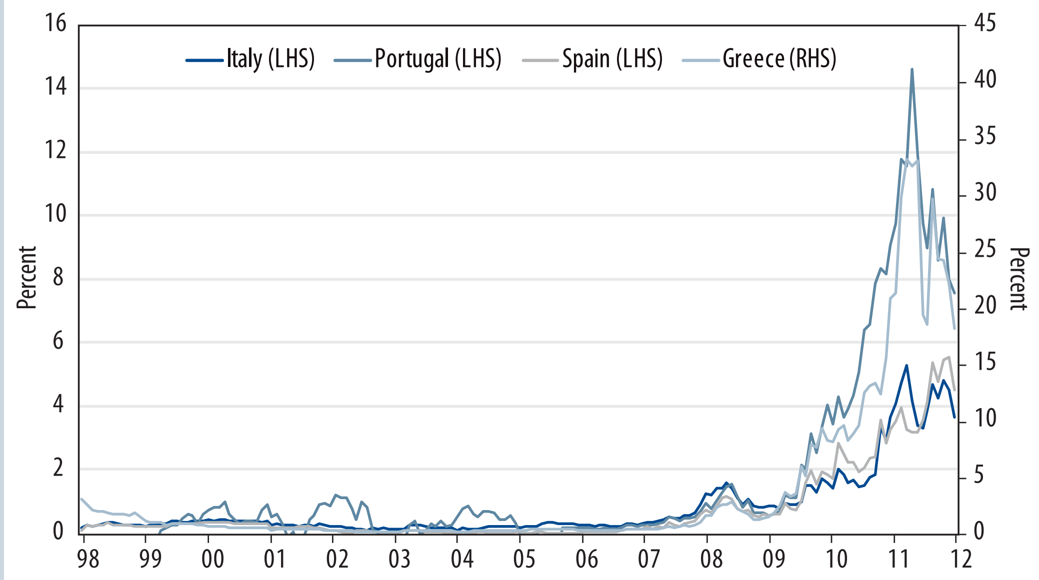
Have policymakers done "whatever it takes" to save the euro?

Executive Summary

European policymakers have made repeated attempts to stem the eurozone crisis. Most have come too little and too late and all have failed to address the fundamental issue, namely, that the eurozone faces a balance of payments crisis, of which the debt crisis is the symptom. Alone, the ECB Outright Monetary Transactions (OMTs) won't address this structural problem. However, this policy change is the first initiative that may buy policymakers enough time to move to an orderly resolution.

The eurozone crisis, as measured by rising spreads of peripheral eurozone countries' government bond yields over German government bond yields, has been with us for nearly three years. European politicians' and policymakers' attempts to avert a crisis, including the provision of loans to indebted peripheral eurozone countries; debt restructurings (defaults, technically); International Monetary Fund (IMF) intervention; three-year longer-term refinancing operations (LTROs);[1] the creation of temporary loan programmes of the European Financial Stability Facility (EFSF)[2] and European Financial Stabilisation Mechanism (EFSM);[3] and the permanent European Stability Mechanism (ESM)[4] have all been designed to provide financial assistance to members of the eurozone in financial difficulty without violating the Lisbon Treaty's provisions. These attempts have succeeded in bringing short-term relief to markets, with every relief rally in spreads and, generally, risk assets either shorter or more muted than the last.

Exhibit 1
Spread of 10-Year Government Bonds Over Germany



Source: Bloomberg

More recently, though, two years and five months after eurozone members' €40 billion, first loan to Greece and two months after European Central Bank (ECB) President President Mario Draghi said the ECB would do "whatever it takes to preserve the euro", we have what markets could properly call a game-changer: the ECB's announcement that it would deploy its balance sheet to buy peripheral eurozone government bonds in the secondary market on a potentially unlimited basis under a new programme that it has termed Outright Monetary Transactions (OMTs). Significantly, in a lesson learned from the debacle surrounding early support for Greece, the ECB will rank pari passu with private creditors. Additionally, the ECB will aim to fully sterilise the liquidity created by the OMTs.

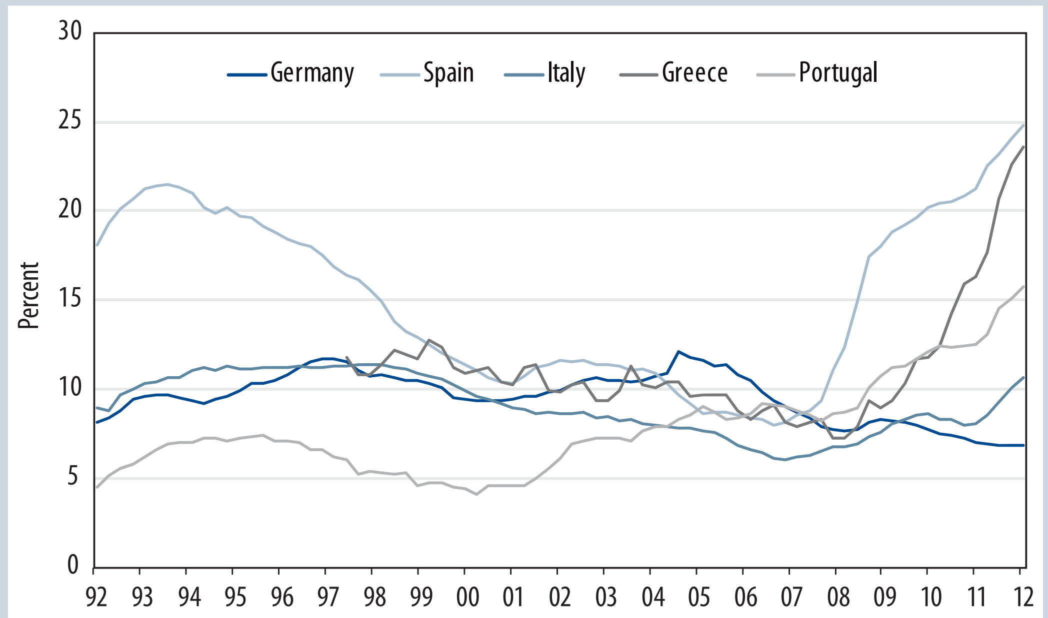
© Western Asset Management Company 2012. This publication is the property of Western Asset Management Company and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

These measures are welcome insofar as they bring some respite from market pressures on sovereign bond yields and, most importantly, time in which to address the eurozone's fundamental issue. Ultimately, the peripheral eurozone countries' debt crisis is a symptom of a balance of payments crisis: once in the eurozone, cheap funding and imprudent capital deployment, wage rises and restrictive labour laws together with inefficient product and service markets contributed to a sharp erosion in those countries' productivity and business competitiveness relative to their neighbours. For years, they imported cheap and abundant capital from northern European lenders to import more than they exported and so fund a current account deficit. With their creditors sharply withdrawing funding, they have now run out of means of funding the deficit in their trade balances. It is the build up in debt in the local banking system and its transfer to governments' balance sheets that has brought the crisis to a head.

The traditional method of restoring competitiveness and of arresting a balance of payments crisis in the short term—currency devaluation—is closed to them so long as they remain in the eurozone. The long-term solution to a balance of payments crisis—GDP growth by means of an improvement in productivity levels and business competitiveness—is a long and hard road back to surplus that continued eurozone membership requires. For that reason, the ECB's intervention is critical in ensuring that debt service costs for deficit countries do not become unmanageable during this transition.

However, there are strings attached to the OMTs: any eurozone country that wishes to benefit from OMT intervention will need to commit formally to meet the necessary country-specific conditions established by an EFSF/ESM programme and by the IMF in return for official aid. These conditions could include the need for more fiscal austerity and direct scrutiny by official creditors of the kind faced by Greece, Ireland and Portugal in recent years. As such, any solutions will be one-sided and deflationary: measures that will mute demand in the periphery rather than increase economic activity—and inflation—in the core.

Exhibit 2
Unemployment Rates



Source: Eurostat

The implications of Draconian monetary policies may be severe because, first, such policies risk a vicious, counter-productive cyclical decline in consumer confidence and spending and, second, they may fuel further social unrest, especially if considered unwelcome because it was imposed by the IMF and by richer, creditor nations. The last few weeks have seen repeated public anti-austerity protests and demonstrations in France, Greece, Portugal and Spain by unions, left- and right-wing party supporters, students and the unemployed in the face of rising joblessness and economic hardship. While headline unemployment numbers in Greece and Spain in excess of 20% are worrying enough, youth unemployment above 50% is a serious concern that leads to questions about 'lost generations' and whether such a price is worth paying to keep the eurozone from fracturing.

The fortunes of Spain, where unemployment among those aged 16 to 24 rose to 53% in July, are key to the impasse.

Spain's economy minister, Luis de Guindos, announced in June that the country would request EU aid to shore up its banking system and the Luxembourg Prime Minister and head of the eurogroup of finance ministers, Jean-Claude Juncker, announced that up to €100 billion would be made available. The EU commissioner for economic and monetary affairs, Olli Rehn, said €60 billion would be made available in November. For now, this injection will be a liability for Spain until a separate, direct injection of capital to the banks can be made by the ESM. Such a direct injection, in turn, is contingent on the formation of a European banking union, ambitiously targeted to be in place at the start of 2013 but meeting stiff resistance from Germany and the Netherlands. Adding to the uncertainty over direct ESM bank recapitalisation is the apparent insistence by Germany, the Netherlands and Finland to exclude legacy bank assets from any aid. In practice, this would mean that funds would not be made available for deep losses on real estate loans currently being held on banks' balance sheets.

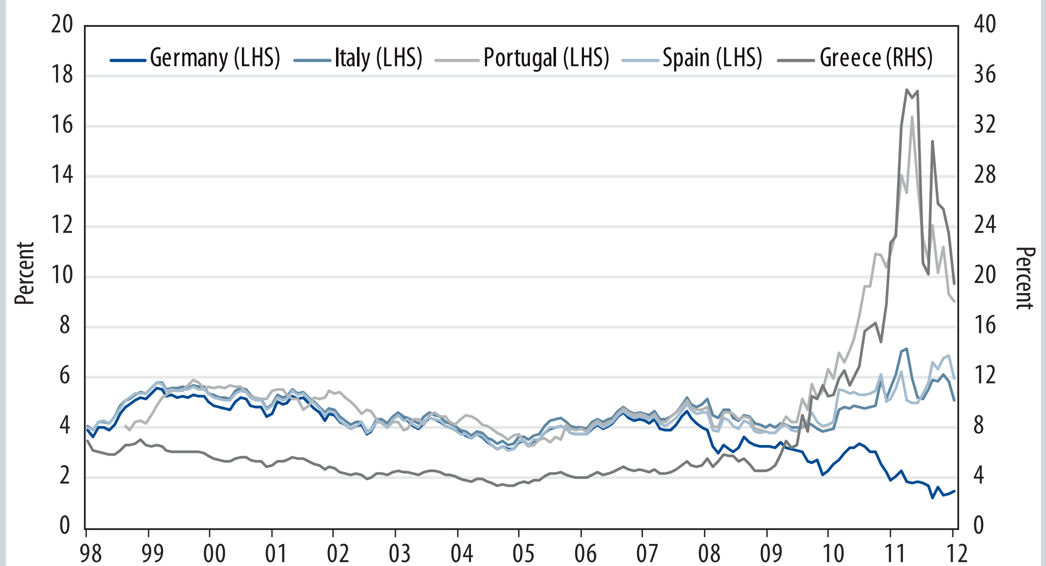
It remains unclear when Spain will make the formal request for assistance from the ESM to help bridge its fiscal liabilities, if at all, given the Spanish government's reluctance to cede sovereignty over fiscal policy to the EU and the IMF. Given this political impasse and Draghi's insistence on "strict and effective" conditionality for OMTs, the entire 'backstop' for Spain and for other peripheral countries is in doubt. Furthermore, the country has to meet €20.3 billion in bond redemptions and to face regional elections in Galicia and in the Basque country on October 21 and surprise Catalan elections on November 25 that were opportunistically called two years ahead of time.

The latter could pave the way to a referendum on Catalan independence that risks plunging Spain into constitutional crisis. Catalonia provides over 19% of Spain's tax revenues but only receives 14% of its national spending. Absent co-operation with the Catalan government on the subject of greater financial autonomy, it will be hard for the Spanish government to press for financial austerity, especially as the country's deficit is already off target. This presents a real problem for the Spanish prime minister, Mariano Rajoy, who has so far rejected the demands of Catalonia's president, Artur Mas, for greater fiscal autonomy and was elected on a promise to enforce budgetary austerity and so avoid the fate of Greece, Ireland and Portugal.

The ECB's balance sheet expansion—in the form of OMTs—will buy the eurozone some breathing space in which to address its structural imbalances, but there remain tremendous tests of political will to come. Not least and most immediately, Rajoy may have calls for Catalan secession and to suffer the ignominy of oversight by the 'Troika'—the ECB, the EC and the IMF—in exchange for the ECB's and the ESM's support of its sovereign bond market. Next year, we have national elections in Italy, that may put an end to this 'eurozone-friendly' technocratic parliament, and in Germany, where tensions between the Bundesbank and the government risk creating a fissure that could be exploited by the non-coalition political parties.

The eurozone must move from temporary bailouts, ECB liquidity backstops for troubled banks and OMTs for troubled sovereigns, that are not long-term solutions, to either full fiscal union with established fiscal transfer mechanisms or a reconstitution of the eurozone. Both will entail politically difficult and lengthy structural reforms to liberalise labour, product and service markets, increase the efficiency of and shrink the size of the public sector, raise the educational skills of a shrinking workforce and formalise sustainable regional budgets. More manageable debt service costs for peripheral eurozone countries and a recapitalisation of banks will certainly ease the pain of these structural reforms but the vicious circle of fiscal austerity and falling tax revenues appears likely to depress growth for some time to come absent a strong recovery in non-EU growth. It is too early to tell if ECB balance sheet provision really does mean that "this time it's different", but the chances of a resolution to the eurozone crisis that entails neither further defaults nor exits have increased somewhat.

Exhibit 3
10-year Bond Yields



Source: Bloomberg

Footnotes:

[1] The ECB instituted three-year longer-term refinancing operations at a rate of 1% in December 2011 and February 2012 amounting to loans totaling just over €800 billion against a wide range of collateral.

[2] The European Financial Stability Facility was created in May 2010 to provide financial assistance to eurozone member states. It is financed by the eurozone member states and is authorised to borrow up to €440 billion. It is due to expire in 2013.

[3] The European Financial Stabilisation Mechanism was created in May 2010 to provide financial assistance to European Union member states and is authorised to raise up to €60 billion on the financial markets under the auspices of the European Commission. It is due to expire in 2013.

[4] The European Stability Mechanism is a €500 billion rescue fund that came into force in September 2012 with the objective of providing financial assistance to eurozone member states on a permanent basis.

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset Management. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset Management may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Limitada is authorized and regulated by Comissão de Valores Mobiliários and Banco Central do Brasil. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered financial instruments dealer whose business is investment advisory or agency business, investment management, and Type II Financial Instruments Dealing business with the registration number KLFB (FID) No. 427, and a member of JSIAA (membership number 011-01319). Western Asset Management Company Limited ("WAMCL") is authorized and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by WAMCL.