



five policy prescriptions for europe

By Tom Fahey, Senior Global Macro Strategist

october
2011

The European sovereign debt crisis continues to hemorrhage risk throughout the financial markets. While investors like to think there is a magic policy response, in our view, the crisis is a chronic illness likely to deliver ongoing bouts of acute pain to the financial markets.

In gauging the outlook for the eurozone, analysts and investors have set forth varying policy prescriptions for troubled countries and the European Central Bank (ECB). The following actions, which are not mutually exclusive, summarize the scope of recommendations.

1. Apply fiscal austerity and hopefully grow out of debt
2. Expand the ECB's balance sheet by purchasing large amounts of sovereign debt
3. Create a fiscal union,¹ issue eurobonds and cede sovereign fiscal authority
4. Restructure or default on sovereign debt, recapitalize banks and start fresh
5. Exit from eurozone membership

APPLY FISCAL AUSTERITY, HOPEFULLY GROW OUT OF DEBT

Troubled countries in Europe are following the first prescription, but growing out of debt will likely take years. There are no guarantees that fiscal austerity will reduce costs, raise productivity and improve the potential rate of GDP growth. Productivity and growth trends for many countries in Europe have been very weak during the past decade. Investing in their sovereign bonds could require a leap of faith that these economies can grow and generate income to service debts. In our estimation, Europe's ongoing challenge will be its ability to grow.

Leading economic indicators in Europe are signaling recession risk as we head into 2012. Against this backdrop, many investors have been losing faith that some European countries, like Italy, will be able to grow and generate enough income to meet debt obligations in the long run. Therefore, the pool of sovereign bond investors is shrinking, making it difficult for countries to refinance large amounts of debt. As a result, risk premiums have risen on the major Spanish, Italian and even French, debt markets.

EXPAND THE ECB BALANCE SHEET

If demonstrating the ability to grow is a chronic challenge, then bouts of acute pain will likely accompany poor economic data and inadequate policy responses. Without economic growth, Europe needs a "Plan B," which leads to the remaining policy prescriptions. Our view is Europe needs a lender of last resort in one form or another to stop the run on sovereign debt. Despite ECB purchases, yields on Spanish and Italian debt remain very high relative to German bonds. In our opinion, the ECB buying program is not convincing investors it will be a true lender of last resort. Expanding the ECB balance sheet could ease the acute pain and anxiety permeating throughout the capital markets. The ECB in theory has unlimited purchasing power and could temper risk premiums if it guaranteed to buy any euro-denominated debt trading outside a certain yield spread to German bonds. However, the ECB appears to be handcuffed by its own rules and its intent to keep the profligate countries' feet to the fire. In addition, as an independent central bank, it has strong objections to monetizing debt. Thus, there is no lender of last resort to support the sovereign countries in crisis.

¹ Fiscal union is the integration of the fiscal policy of nations or states. Under fiscal union, decisions about the collection and expenditure of taxes are taken by common institutions, shared by the participating governments. (Wikipedia)



FISCAL UNION

Even if the ECB were to expand its balance sheet, it would only be buying time, because monetary policy has a limited impact on long-run potential growth. The next policy prescription, a fiscal union and eurobond issuance, would create a quasi-lender of last resort for the sovereign bond market. The market is experiencing a run on sovereign bonds and there is no institutional backstop in Europe to stem it. Some call the lack of a fiscal union the fatal flaw of the eurozone because a fiscal union could restrict profligate spending by weaker members while facilitating transfer payments to sovereigns facing a liquidity crisis. In our view, once the eurozone countries gave up their sovereign currencies and the ability to control their own money supplies, which could service debts indefinitely, a backup liquidity facility was needed. The European Financial Stability Facility (EFSF)² has some resemblance to a fiscal union because it provides liquidity to sovereigns that have lost access to the capital markets. However, with only €440 billion in lending power, it has a very limited scope, especially considering the €300 billion in debt Italy has to refinance during 2012.

Investors talk of leveraging the EFSF's assets to €2 trillion in order for the facility to be a credible lender of last resort for the sovereign bond markets. A leveraged EFSF could ease the acute pain hitting the markets. However, the ECB would probably be called on to supply the leverage, thereby expanding its balance sheet—something it seems reluctant to do. Leveraging the EFSF through the ECB could be an option worth pursuing if it allowed the ECB to circumvent its rules of operation; however, the ECB Governing Council appears split over the potential merits of this proposal. Alternatively, turning the EFSF into an insurance scheme that absorbs the first 20% to 40% of losses could perhaps also work to leverage the fund size toward a more meaningful amount in the €1.5 to €2 trillion range. These are creative options that have the potential to reduce the pain in financial markets; however, short of growing out of debt, these options would just transfer the credit risk without eliminating it.

A fiscal union could be a nice addition to the structure of monetary union, but we don't believe it is likely to form any time soon. The political objections are significant; it would require treaty changes, unanimous member acceptance, and lengthy democratic debate because it would leave huge contingent liabilities on the balance sheets of each sovereign country, particularly the larger countries of France and Germany. The German constitutional court on September 7 threw cold water on the potential for eurobonds when it said, "the *Bundestag*, as the legislature, is also prohibited from establishing permanent mechanisms under the law of international agreements which result in an assumption of liability for other states' voluntary decisions, especially if they have consequences whose impact is difficult to calculate." A fiscal union would require significant centralized control over fiscal policy—a development few countries seem willing to cede at this point.

RESTRUCTURE OR DEFAULT ON SOVEREIGN DEBT— RECAPITALIZE BANKS

That brings us to the fourth policy prescription. Reducing the debt overhang is critical to helping the European economy improve its growth prospects. Removing the threat of default and uncertainty that comes with excessive debt levels could help improve the real capital investment decisions that drive GDP growth. If a country is unable to grow and meet its obligations, default and debt restructuring have to be part of the solution. The question then becomes who owns the debt and whether they are strong enough to take the loss. It is this uncertainty that is infecting the capital markets—who is going to take the haircut³ on the debt and will it cause a domino effect throughout the financial system?

The IMF calculates that the sovereign debt crisis in the high-risk countries of Greece, Ireland, Portugal, Italy, Belgium and Spain is affecting €300 billion in assets. This is not an estimate of potential losses but gives an idea of the scale of assets being affected. On the positive side, €300 billion is equivalent to only 3% of eurozone GDP.

² The EFSF was created by euro-area member states in 2010. According to the organization, its mandate is to safeguard financial stability in the eurozone by raising funds in the capital markets to finance loans for euro area member states (www.efsf.europa.eu).

³ A haircut is a percentage that is subtracted from the market value of an asset being used as collateral (Wikipedia).



EXIT EUROZONE

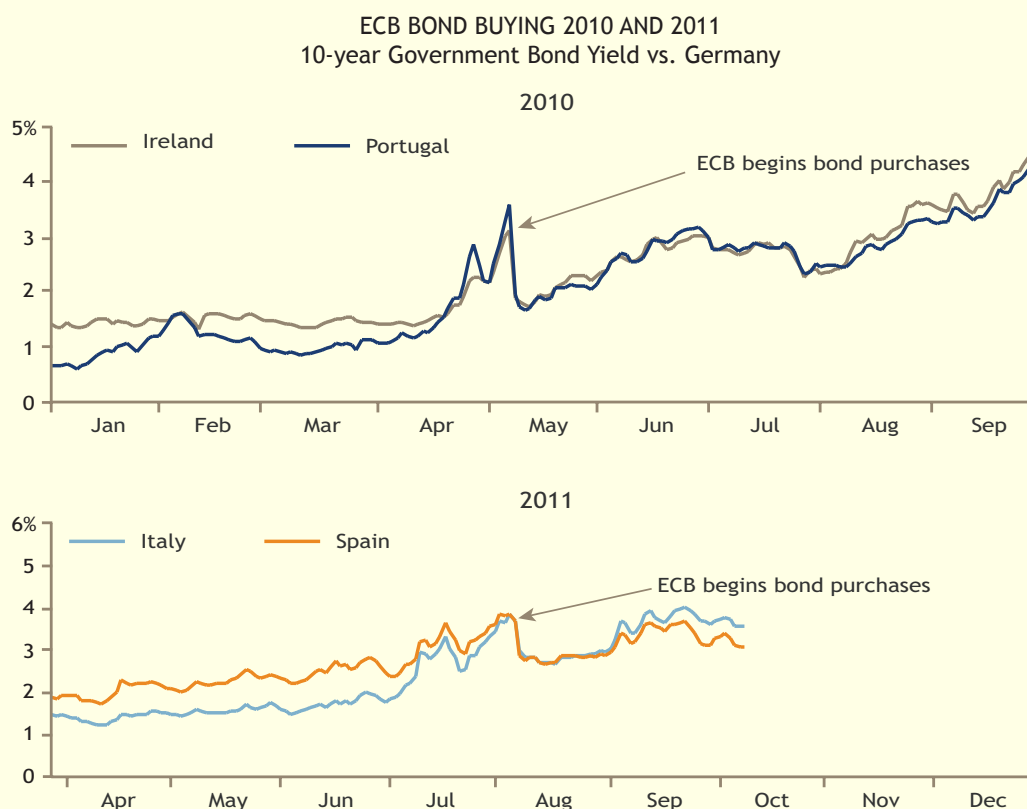
The final prescription, troubled countries exiting the eurozone, still seems like a very low probability event. Anything can happen, but the cost and complexity of exiting the euro would be significant. The founding members of the euro explicitly created a “no-exit” clause because one country leaving could damage all members of the eurozone.

The exiting country, after becoming insolvent under the burden of euro debts, would still have to apply fiscal austerity, raise a primary balance surplus and recapitalize its banks and corporate sector. We believe countries would choose to default and restructure but stay within the eurozone. After all, the relatively healthy euro members are doing a worthy service to troubled countries by providing them with liquidity while exposing their sovereign balance sheets to large contingent liabilities.

CONCLUSION

The European sovereign debt crisis is chronic. It can not be resolved until countries can demonstrate the ability to grow and improve their budget deficits. The immediate need is to stop Europe from hemorrhaging risk into the global financial markets. That can only be done by the ECB because it is Europe’s most effective and high profile euro-area institution and the banking system’s only lender of last resort. Until the ECB steps up to commit sufficient liquidity, the overall septic conditions of European risk will likely continue to infect the global capital markets.

THE ECB NEEDS TO DO MORE BUYING...



Source: Thomson Reuters Datastream. Reuters graphic: Scott Barber, as of 10/10/11.

This report is provided for informational purposes only and should not be construed as investment advice. Investment decisions should consider the individual circumstances of the particular investor. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only. There can be no assurance that developments will transpire as forecasted and actual results will be different. Other industry analysts and investment personnel, including those within Loomis Sayles, may have different views and assumptions. Portfolio managers may make investment recommendations that are not consistent with this information. The information does not represent or imply the actual or expected performance of any Loomis Sayles product. Accuracy of data is not guaranteed but represents our best judgment and can be derived from a variety of sources. The information is subject to change at any time without notice.

MALR008414 LEGREV033012