The Draghi effect – no quick fix for eurozone crisis

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There is still a risk of one or more countries leaving the eurozone, despite two multi-billion euro bailout funds and two massive injections of cash from the European Central Bank (ECB) into the banking system. We think this is because liquidity is only a temporary fix. It will take a significant dose of structural reforms and the return of growth within the European Union to end the crisis.

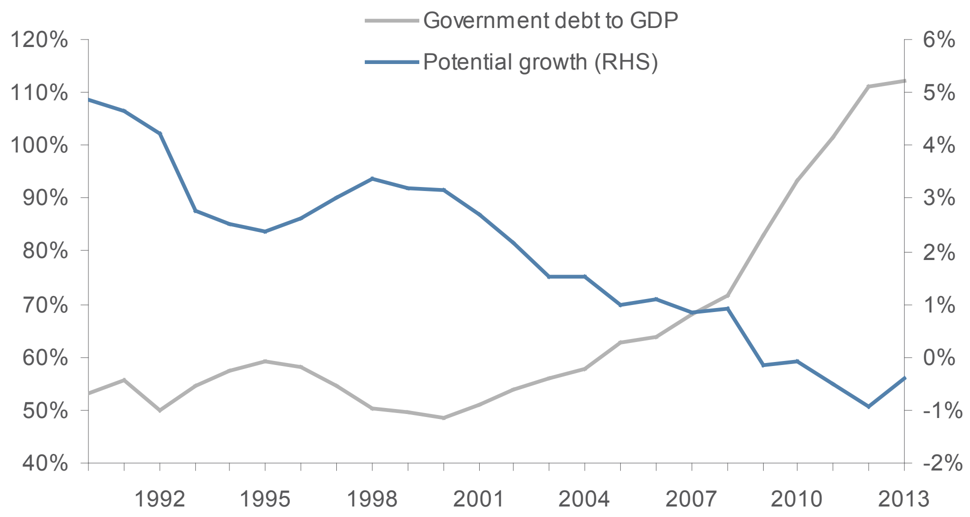
In 2010, euro area member states joined forces to put together the European Financial Stability Facility (EFSF) which has administered bailouts to Portugal and Ireland. The facility, which will soon be replaced by the new European Stability Mechanism (ESM), is worth about EUR200 billion, after ongoing commitments, including those for the second Greek Bailout.

Despite this effort, even when we add in the resources of the International Monetary Fund, total funds available are not enough should the crisis spread to the larger economies of Spain and Italy.

Portugal's example shows how low growth is a key structural issue in the eurozone crisis, unlikely to be addressed by ECB policies. Potential GDP growth collapsed from around 5 per cent in the early 1990s to a negative rate in 2011. At the same time debt has skyrocketed, due to lax fiscal discipline, lack of growth and the pre-crisis availability of cheap credit, leaving huge refinancing requirements that mean the country is unable to meet its commitments on its own, as evident by the bailout.

Liquidity measures have now been put in place by the ECB to reduce the chances of a meltdown in the European banking sector, also resulting in a lower default risk on eurozone sovereign debt.

Portugal: Potential growth and debt to GDP



Source: RBS European Economics and European Commission.

These actions are particularly important for Italy and Spain, ensuring that demand exists for their sovereign bond issues and allowing both countries to finance themselves.

The central bank has attacked the crisis on two fronts, initially by the direct purchase of Italian and Spanish sovereign bonds in the secondary market and more recently with the creation of the Long Term Refinancing Operation (LTRO) which gives European banks cheap loans (around 1 per cent per annum), in exchange for collateral, and helps them indirectly to buy sovereign bonds.

As a result of this additional support to the system, interest rates paid by the Italian and Spanish governments to investors in their bonds has reduced dramatically from their recent peak in November last year.

In our view this can only be achieved by a pooling and sharing of debt across the entire eurozone in order to increase investor confidence.

The EFSF/ESM fund attaches conditions to bailouts so countries receiving money must agree to austerity measures such as job cuts and wage freezes, creating opposition to the eurozone. The ECB does not attach conditions to its bond buying, but it does insist on being paid first in the event of default, making private investors wary of losing their money. The effect of both measures is to diminish the appetite for investors to finance sovereigns which have difficulties, and to potentially increase the exit risk premium of those countries.

Risk of eurozone exit is difficult to calculate, and even more difficult to protect against.

Italian 2 year bond yields have fallen by more than 5 per cent since November 2011

Source: Bloomberg

This is exactly what was intended and has reduced the premium attached to the default risk of Italy and Spain and made it far cheaper for them to raise money in the capital markets. We forecast that Italy will issue bonds worth EUR219 billion in 2012, with a challenging refinancing pipeline in years to come. The country needs to find buyers for that debt at a reasonable cost, in our view, to avoid the need for a bailout itself.

These combined actions have averted a crisis of confidence. But in order to find a permanent solution for the eurozone and safeguard market stability, the risk of weak countries exiting the currency union must also be reduced.

Investors are fairly certain in their belief that exit will devalue assets held in the country, but they are unable to buy a hedge against that risk as they can against foreign exchange or interest rate risk. As a consequence, the exit risk becomes an important factor to consider when deciding on where to invest.

The result of elevated exit premiums is a steady withdrawal of private sector investment from the peripheral European countries by the core countries. RBS analysis shows that outstanding claims on Greece from foreign banks have fallen by EUR121 billion since Q3 2009, the equivalent of 56 per cent of the country's GDP. The analysis also shows that, in Ireland it is EUR182 billion, or 117 per cent of GDP.

The reduction of foreign investment creates a vicious circle, contributing to more unemployment, less growth, lower tax income and bigger deficits, leading to an even greater chance of exit.

If the monetary union can reform its structure and implement an automatic stabilisation mechanism that is big enough and credible enough to share the problem, then peripheral countries can be stabilised.

The core countries need to share their good credit quality with the rest of the eurozone and help increase the flow of foreign investment to the periphery countries.

When exit risks are addressed default risk premiums should fall without the need for artificial ECB intervention, and those countries will be able to fund themselves more easily. They should also be able to attract inward investment from abroad into the real economy, driving up growth and allowing trade deficits to be erased. The end result should bring about a gradual end to the European sovereign debt crisis.

A failure to address these issues is likely to result in the increased risk of eurozone exit for one or more countries, which we believe could have extremely negative consequences for the future of the euro area.

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180-0312