

Europe: Close to the Edge

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Introduction

Over the last six months the sovereign debt crisis in Europe has deteriorated dramatically. A combination of weakening economic growth and the lack of clear crisis resolution policies has resulted in significant financial markets disruption, which since August has spread across all global markets. While there are issues of concern elsewhere, uncertainty over Europe's future and its ramifications for the rest of the world continue to dominate investors' minds.

In this edition of *Monthly Insights* we focus on the European situation. To start, we consider the original rationale for the foundation of the European Union (EU), noting that its *raison d'être* likely transcends optimal economics. Given this, the underlying commitment of the core countries to the European project in general, and European Monetary Union (EMU) specifically, should not be underestimated.

The recent involvement of Italy and Spain in the crisis has raised the stakes considerably for policymakers and market participants. The exposure of European banks to these countries—particularly to Italy—means that the threat of financial contagion is large. We believe that the Italian situation is very different from that of the smaller Mediterranean countries. Italy's challenge is one of liquidity rather than solvency. By providing credible, unlimited backing to Italy and other troubled but solvent governments, the European Central Bank (ECB) can help anchor private sector expectations, relieve funding pressures and put the countries on sustainable financial and growth paths.

In contrast to Italy and Spain, we believe the Greek government is facing a solvency crisis. A well-managed and ring-fenced Greek default, followed by debt restructuring, should be high on the European agenda. A scheme to support exposed banks and build a strong firewall around solvent governments will be very important in preventing undesirable spillovers. This would remove the chief source of uncertainty from financial markets and put Greece onto a long but more realistic road to achieving growth and sustainability.

We also look at the policy initiatives that could help Europe navigate the crisis in the short term and return to a desirable equilibrium in the long term. Clearly, the range of future outcomes today is very diverse. We include a *Box* where Jonathan Bayliss from GSAM's Global Fixed Income team explores the multiple equilibria that can arise under the current framework and the paths that may lead Europe to each of these outcomes.

Finally, we remind our readers that countries outside Europe, in particular Growth Markets, continue to play a vital role in sustaining global growth at a reasonably sound level. If Europe continues to "muddle through", there are a variety of policy options available to Growth Markets that should enable them to successfully steer their economies through the ongoing global slowdown. Even these countries, however, will not be immune to a messy unravelling of the European crisis.

The Roots of the Economic and Monetary Union

When considering the future of Europe and the EMU, it is important to keep in mind the origins of the European project. In many ways, the social and political goals for the European Union took primacy over economic ones. Designed and implemented by a generation of people that had been raised in the aftermath of World War II, the EU was seen by many as a means of preventing future conflict.

Given the economic similarities between the core countries—West Germany, France, Benelux and Austria—a monetary union involving these members made sense from an economic perspective. However, expanding the area to include Club Med, Finland, Ireland and others has arguably created even greater divergences within Europe's economies and has added to the existing challenges of managing the EU. A single monetary policy covering such a diverse mix of countries is sub-optimal and the ongoing crisis is exposing all its flaws.

Today the case for the EU, and by association the EMU, is becoming less powerful. We see two main forces at work that weaken the pro-EU arguments. First, the **changing nature of the global economy** undermines the economic case. World trade patterns have changed dramatically over the past decade, as the source of global growth has shifted towards the BRICs and other Growth Markets. Specifically, Germany is seeing a major shift in its export markets, with China and other BRICs rapidly ascending in importance, as *Exhibit 1* demonstrates. For a monetary union that had questions about its optimality for all the members that joined in 1999, the rise of Growth Markets adds to the challenges.

The second factor that could further undermine the EU rationale is **generational change**. As a future generation of European leaders emerge over time, history may not be so

persuasive to them, and the will to maintain the EMU might weaken, especially if the economic benefits are not so apparent. A younger generation of voters may hasten this process. In this respect, perhaps it is good that the European crisis is occurring now. This way, the responsibility for solving the problems plaguing the EMU lies with those who created and implemented it.

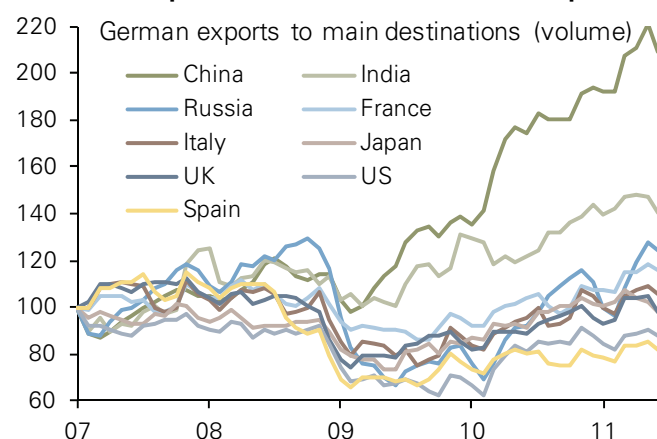
Nevertheless, the political will to continue with the European project continues to be strong. While there are ongoing disputes between the European politicians (particularly in Germany) on the policies aimed at the Eurozone rescue and the role of the ECB in it, we believe Germany remains strongly committed to the European project. When asked recently if belonging to the EU had been a good thing for their economy, 76% of Germans responded with an emphatic yes. However, when the question referenced the single currency the response was more equivocal with approximately 50% remaining positive.¹ A strong commitment from European leaders to the European project, and to the Euro in particular, is what is needed today. A break-up of the EMU, in whatever shape or form, is likely to be much more costly and unpredictable than a decisive rescue plan.

Italy Raises the Stakes

Last July, amidst the ongoing troubles in the periphery, Italy and Spain came into the spotlight. Credit spreads in Italy widened dramatically from approximately 2% over a 10 year Bund to nearly 4% a month later, as *Exhibit 2* illustrates. This has contributed to the sharp divergence in financial conditions between the periphery and the core we have seen in the last six months, and combined with Italy's recent downgrade by Moody's, is now serving to compound the problems.

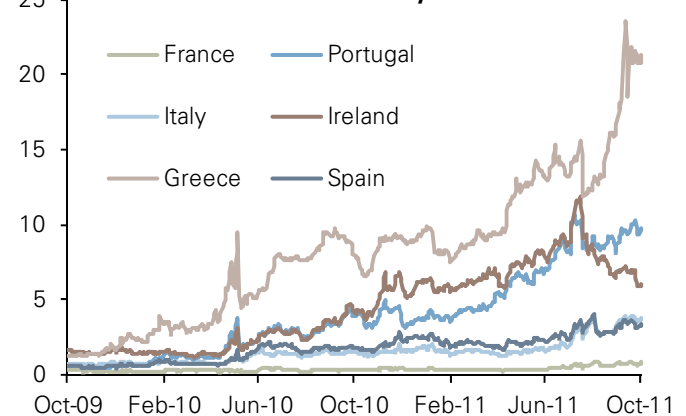
The involvement of Italy and Spain has raised the stakes of getting things right considerably. Spain's economy is twice

Index, Jan '07=100 **Exhibit 1 - Growth Markets Are Becoming Important Destinations for German Exports**



Source: Haver Analytics and GSAM Calculations

% **Exhibit 2 - Italian and Spanish Spreads Over German Bunds Have Widened Significantly Since July**



Source: Datastream and GSAM Calculations

¹ German Marshall Fund Survey, 14/09/2011. Sourced from Bloomberg.

the combined size of Greece, Portugal and Ireland. Italy's economy is the eighth largest in the world and four times the combined size of these countries. As is well known, Italy has the third highest \$ or Euro value of sovereign debt in the world after Japan and the US.

The exposure of European banks to Italy and Spain suggests potential for financial contagion could be large. According to the European Banking Authority, while sovereign and interbank exposure at default to Greece remains manageable at 0.4x Core Tier 1 capital (CT1), their exposure to Italian and Spanish debt is substantial.² *Exhibit 3* shows the sovereign and interbank exposure of European banks to Greece, Italy, Ireland, Portugal and Spain as a multiple of their 2010 CT1. It should not be a surprise that these countries' banks have very high exposures (many multiples their CT1) to their domestic debt. What is concerning is the degree of exposure of French and German banks at approximately 2.5x CT1. Should Italy, the largest of the troubled countries, be deemed insolvent, the banks would transfer sovereign troubles to the real economy across Europe and further afield through a ceasing up of credit supply.

Negative market dynamics can turn a solvent government insolvent via self-fulfilling expectations. If investors believe that a country faces *potential* solvency issues, they will shun the country's debt and precipitate an *actual* solvency crisis. It is important to note that we do *not* believe that Italy is insolvent. So far, Italy's problem is one of liquidity, not solvency. This provides a good rationale for continued support by the ECB. As *Exhibit 4* shows, Italy is expected to run a small primary (ex. interest payments) surplus this year. If Italy is able to push through the necessary structural reforms and return to a more positive growth trajectory, the case for Italy's solvency becomes even stronger. By providing credible unlimited backing to solvent

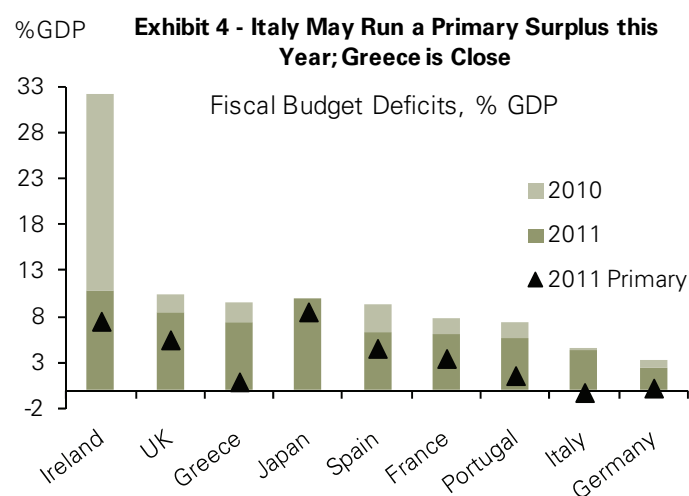
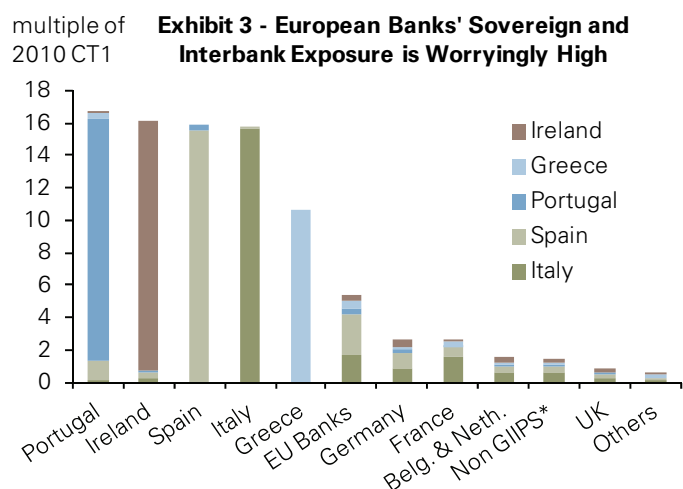
governments, the ECB can help anchor private sector expectations. This should help prevent a self-fulfilling default, relieve funding pressures and put governments on sustainable financial and growth paths. Of course, Italian policymakers will have to show their commitment to reform for this to occur.

Is Greek Default A Done Deal?

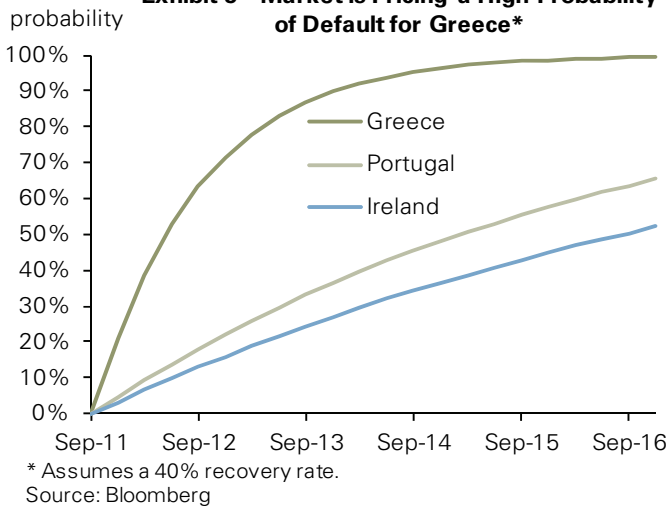
In contrast to Italy and Spain (and arguably the rest of the periphery), the Greek government *is* insolvent and debt restructuring is needed. Greece's growth and debt dynamics suggest it might need a much more dramatic restructuring of its debt than has been suggested so far. As *Exhibit 5* shows, assuming a 40% recovery rate, the credit default swap (CDS) market is effectively pricing in a Greek default as a forgone conclusion. The implied probability of default for Portugal and Ireland is much lower but still high.

The spectre of a Greek default is unnerving to investors due to the uncertainties regarding the repercussions of such an event for both Europe and the rest of the world. A default would threaten banks not just in Greece, but most European banks with related exposure. An exit from the Euro by Greece would set an unhealthy precedent and would be very painful domestically—at least at this point in time. It would lead to bank runs, a sharp devaluation of the new currency, capital controls, numerous bankruptcies of domestic companies with foreign exposure, and pressure on other countries in Europe and outside.

With this in mind, we believe that a well-managed and ring-fenced Greek default, with no exit from the Euro, should be high on the European agenda. A scheme to support exposed banks, a strong firewall around solvent governments and credible promises of support are some of the key measures that should prevent undesirable spillovers. The ECB's continued commitment to providing



² European Banking Authority 2011 EU-Wide Stress Test Aggregate Report, 15 July 2011. For further details on this see "Stress test II: Banks not buckling under EBA's stress; focus moving to connectivity", Goldman Sachs Equity Research, 18 July 2011.

Exhibit 5 - Market is Pricing a High Probability of Default for Greece*

unlimited liquidity and another expansion of the EFSF (possibly leveraged or funded, or both, by the ECB)³ should be immediate policy initiatives. This would remove the key source of uncertainty from the markets as well as put Greece on the long and more realistic path to achieving growth and sustainability.

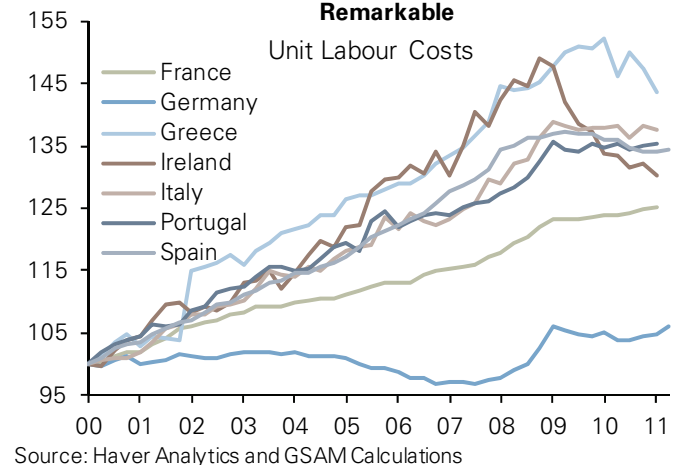
Deep-Rooted Problems Persist

In addition to the near-term issues that European countries are facing, deep structural problems need to be addressed effectively to ensure the EU's survival. We see three broad areas worth highlighting.

Competitiveness in EMU

The issue of divergence in competitiveness between the core and periphery—or predominantly between Germany and the rest of the EU—is well known. As *Exhibit 6* shows Germany has managed to keep its unit labour costs (ULCs) roughly flat over the past decade, while others have seen substantial increases, of the order of 50% in the case of Greece. As the BRICs significantly expanded their influence over the last 10-15 years, the nature of the competition in global markets has changed markedly. A pool of cheap labour and products from the traditional emerging market universe has put substantial pressure on struggling European manufacturers and their rigid labour markets. Countries that managed to implement necessary structural reforms have stayed competitive—Germany is the chief example in this group. Ireland has also shown a material improvement in competitiveness since 2009. Others, however, have lagged behind.

For the monetary union to exist, particularly in the context of a closer fiscal integration which we believe is a necessary long-term route, this underlying problem has to be resolved. Without the levers of national monetary policy and individual

Exhibit 6 - Divergence in Competitiveness Between Core and Periphery Has Been Remarkable

exchange rates, supply-side reforms and internal devaluation are two methods to restore competitiveness in the region. While the latter is clearly unattractive, the former is feasible and thus should be a priority for those lagging behind. Of course, some countries are already making steps in this direction by following the International Monetary Fund (IMF) programmes.

Incentive Structures

As this crisis has shown, the EMU does not have an effective incentive structure in place to ensure that all countries continuously meet the preconditions for the success of the Euro. Today, out of all the countries in the EMU, only Finland and Slovenia satisfy the Maastricht Treaty criteria. Excess and imbalance built up in the Euro area's periphery partly because these countries could borrow against the creditworthiness of their core partners and gain access to capital at a lower cost than they would otherwise have. Cheap credit also helped them mask their competitive problems. Enforcing fiscal discipline has been hard, particularly because Germany and France were among the first countries to break it in 2002, setting a precedent which has exacerbated moral hazard.

Changing the incentive structure for the union members should be another high priority policy initiative. What could work? A constitutional endorsement of fiscal discipline could be one measure, although this alone is unlikely to be sufficient. A whole host of policy measures and perhaps new institutions with an independent revenue base would be required.

The Role of the ECB

With its enormous firepower, the ECB is currently playing a crucial role in ensuring the survival of the Euro area. Its commitment to the unlimited liquidity provision to solvent

³ There have been several proposals that speculate as to how the EFSF could be bolstered. It is unlikely to be done by private investors at this stage nor by governments in a suitably short space of time. This leaves the ECB to effectively leverage up the Facility, either directly or indirectly. The ECB could do this by allowing the EFSF to repo its securities with it, for example.

governments facing illiquidity issues has so far helped support Spanish and Italian bond markets, and will continue to be a crucial element of any crisis resolution scenarios.

However, given the ECB's mandate, such unconventional measures have been controversial, particularly amongst its own members. Some believe that the ECB is losing its independence. One argument is that these measures are incompatible with low and stable inflation and that purchasing sovereign debt gives it a quasi fiscal role. It is feared that the ECB could lose its credibility, especially by getting involved in political decisions.

While all these arguments probably do hold in the long term, it seems that in the current environment some of them are less relevant. Today the ECB is the only European institution that has the capacity to provide life support to troubled governments and to prevent the monetary union from collapsing.

Likely Future Policy Initiatives

Undoubtedly, what we need to see from European policymakers today is credible and proactive leadership. A strong firewall to ring fence Greece in an event of a default, including recapitalisation of Europe's most vulnerable banks—the main transmitters of financial contagion—as well as measures to support solvent governments (by the ECB and EFSF), should be top priority. In this respect, the November G20 meetings will be important for agreeing the details of this.

We also believe that together with providing liquidity support, the ECB should reverse the rate hike undertaken earlier this year. Given the rapid deceleration in the Eurozone's coincident indicators and relatively low inflation, it seems hard to justify its hawkish stance. Preventing illiquidity issues and stimulating growth should be the top two priorities for the ECB's policymakers.

In the medium to long term, policy initiatives are needed to address the deep rooted problems within the EMU. Given the eroding competitiveness and weak incentive structures exacerbating moral hazard, the EMU must gravitate towards a stronger fiscal union, with higher levels of economic integration and some aspects of political union. A single Euro-denominated bond market should eventually follow, with perhaps some new institutions such as a Euro area Finance Ministry with its own independent revenue base.

Of course, the path ahead is likely to remain rocky and volatile. Clearly, the range of future outcomes is very diverse. In the *Box* on the next page Jonathan Bayliss from GSAM's Global Fixed Income and Liquidity Management team discusses the multiple equilibria that can arise under the current framework and the paths that may lead Europe to each of these outcomes.

Could Growth Markets Come to the Rescue or Get Derailed by the EU Crisis?

As we have highlighted before on numerous occasions, it is important to keep the European crisis in perspective. We believe Growth Markets could boost global GDP by around \$16 trillion this decade. This increase will likely represent about four times that of the US and around double that of the US and the Euro area put together. China alone will probably be responsible for around half of the growth generated by Growth Markets. With this in mind, watching events in these economies, and China in particular, is rather important.

We do not believe that China (and other BRICs) will bail out Europe directly. Despite some speculation, a number of policymakers including the Chinese Premier have made this clear. However, two things are worthy of note in this respect. First, as full G20 members, BRICs will be able to participate in the Eurozone rescue indirectly in the upcoming G20 meetings in November. Second, it is also interesting to see the BRIC countries talking about possibly diversifying more reserves into European markets. While it is tough to believe that the BRIC countries can coordinate any additional EMU bond purchases between them, it is not difficult to see how they (and other wealthy reserve countries) would want to buy more bonds from a region where policy is clearer.

Whether Growth Markets themselves get derailed by the EU crisis, of course, depends on which scenario ends up playing out in Europe. If Europe continues to "muddle through", Growth Markets will remain standing on their own feet. With a variety of policy options still available, they should be able to navigate the external uncertainty and steer their economies through the ongoing global slowdown.

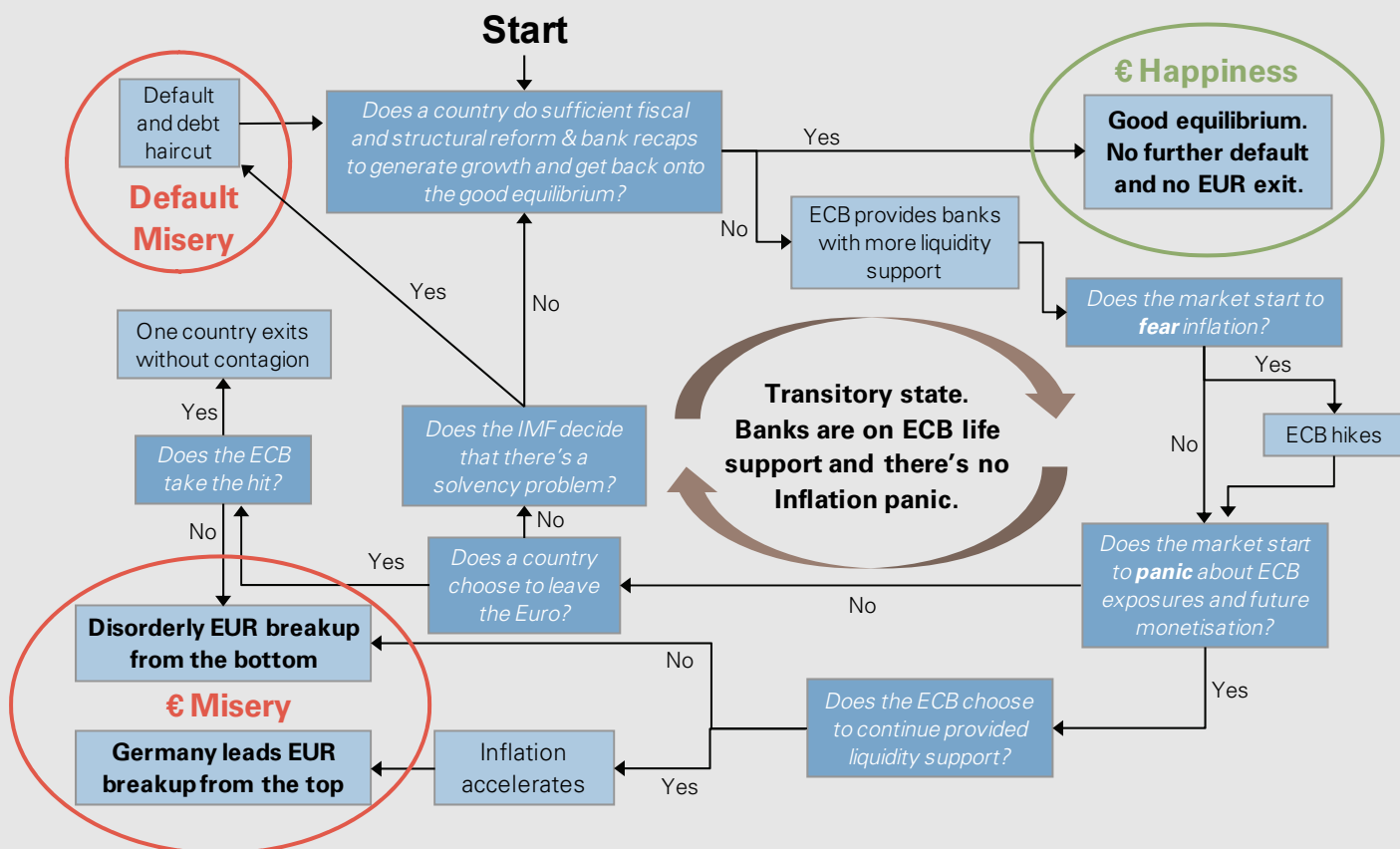
But in a less desirable scenario which gives rise to significant contagion, Growth Markets will not be immune. Given their size and role in the global economy, they are closely linked to Europe. Financial stress and uncertainty will be transmitted quickly via financial and trade channels, hurting banking systems, investors, companies and subsequently the real side of their economies. Needless to say, the degree of damage would depend on the exposure to Europe—and some Growth Markets are more vulnerable than others. In our next *Monthly Insights* we are planning to explore these linkages to gauge who might be most vulnerable and who can stand strong, given the policy tools in hand.

By Jonathan Bayliss in GSAM's Global Fixed Income and Liquidity Management team

good equilibrium and it does not need any more ECB liquidity support. If the market thinks “no”, then the ECB provides more liquidity support until either inflation concerns rein back the ECB’s liquidity operations or Greece chooses to leave the Euro. If neither of these happens, we repeat the cycle, asking again if there is enough of a growth model for Greece to stand by itself.

Other troubled countries today are also in a transition state between the good and bad equilibria and are essentially on temporary life support from the IMF, EU and ECB. In addition to Greece, Ireland and Portugal are currently getting liquidity support under adjustment programmes administered by these institutions. Italy and Spain are getting liquidity support through the ECB's secondary market bond buying programme. We hope these countries can make sufficient adjustment to move firmly back into the good equilibrium of strong growth, low deficits and low bond yields.

Taking Greece as an example, we start at the top and ask if there is enough of a growth model for Greece to stand by itself. If the market thinks “yes”, then it moves to the



Source: GSAM

Appendix

GDP Growth Forecasts: Consensus vs GS Global ECS Research

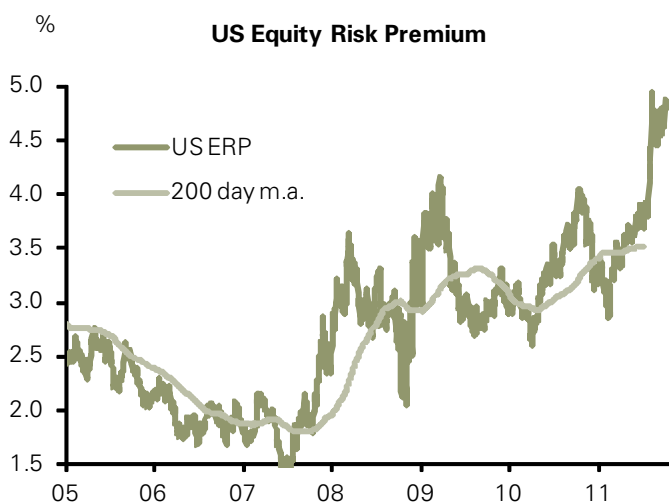
	2010	2011 (f)		2012 (f)	
%yoy	Actual	Consensus*	GS Global ECS**	Consensus*	GS Global ECS**
USA	3.0	1.6	1.7	2.1	1.4
Japan	4.0	-0.5	-0.6	2.4	2.2
Euroland	1.7	1.7	1.6	1.0	0.1
UK	1.4	1.2	1.1	1.8	1.0
Brazil	7.5	3.9	3.5	4.1	3.3
China	10.3	9.1	9.1	8.6	8.6
India	8.5	7.5	7.0	8.4	7.4
Russia	4.0	4.3	4.2	4.3	3.5
BRICs	8.8	7.6	7.4	7.5	7.2
Advanced Economies	3.0	1.7	1.6	2.1	1.3
World	5.1	3.9	3.8	4.1	3.5

* Consensus Economics Sept-11. ** Goldman Sachs Global Economics, Commodities and Strategy Research

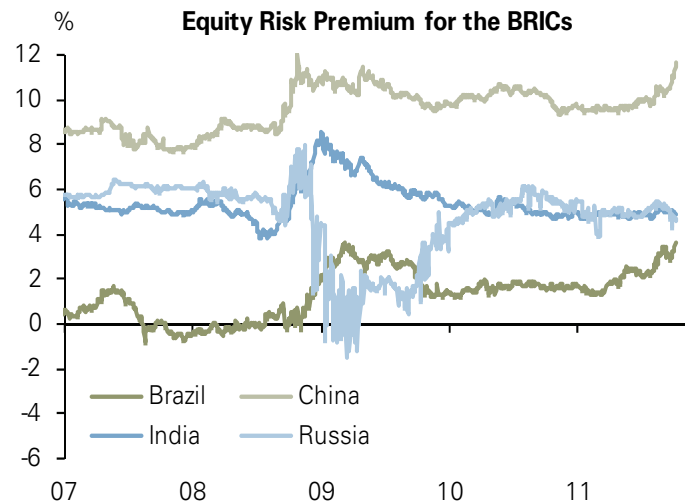
Global Equity Risk Premium*

	Real GDP Growth Trend	Real Earnings Growth	Dividend Yield	Expected Real Return	Real Bond Yield	Implied ERP	Expected Inflation	Expected Nominal Return
US	2.5	2.5	2.3	4.8	0.0	4.8	2.0	6.8
UK	2.3	2.3	3.7	5.9	-1.0	7.0	2.0	7.9
Europe ex UK	2.0	2.0	4.1	6.1	0.7	5.5	2.0	8.1
Japan	1.5	1.5	2.4	3.9	1.2	2.7	0.5	4.4
Brazil	5.0	5.0	4.3	9.3	5.7	3.6	4.5	13.8
China	8.0	8.0	4.5	12.5	0.9	11.6	3.0	15.5
India	8.0	8.0	1.4	9.4	4.5	4.9	4.0	13.4
Russia	5.0	5.0	2.7	7.7	3.1	4.6	6.0	13.7
GDP-weighted								
Advanced	2.2	2.2	3.1	5.2	0.4	4.8	1.8	7.0
BRICs	7.0	7.0	3.8	10.8	2.6	8.3	3.8	14.7
World	3.4	3.4	3.2	6.6	0.9	5.7	2.3	8.9
PPP-weighted								
Advanced	2.2	2.2	3.0	5.2	0.3	4.9	1.8	7.0
BRICs	7.3	7.3	3.6	10.9	2.5	8.4	3.7	14.7
World	4.1	4.1	3.3	7.4	1.1	6.2	2.5	9.9

* As of 04 October 2011. Source: GSAM calculations



Source: GSAM calculations



Source: GSAM calculations

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