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The European Crisis: Is a Default Scenario Unavoidable?

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- The European crisis has worsened, hitting Italy with force and with effects on the health of the European financial system and the borrowing costs of sovereigns much beyond the PIIGS.
- As has become a custom by now, the most recent program announced on October 27th by the heads of state of the Euro area was too-little, too-late.
- Towards the middle of October there was a wide recognition that the control of the crisis required a comprehensive and strong program that should include:
  - (1) a large discount on the Greek debt;
  - (2) a recapitalization of the European banking system;
  - (3) strong structural adjustment programs in Greece, Portugal, Italy and Spain aiming at reducing the fiscal deficits, facilitating the adjustment and restoring medium term sustainable growth;
  - (4) a large fund to protect the countries that are still solvent, have to adjust, but could become insolvent due to severe liquidity problems.

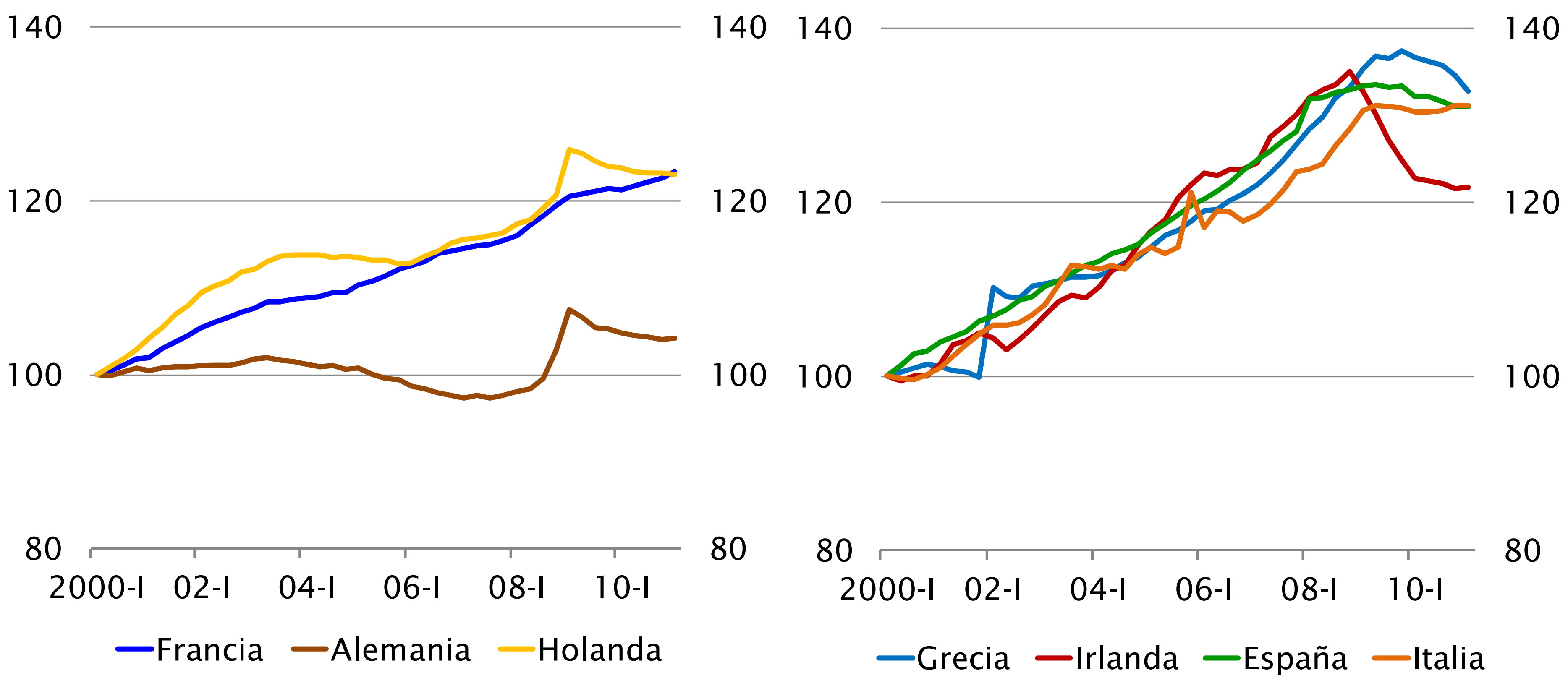
- The October 27th program made progress on a discount on the Greek debt, some progress on the recapitalization of banks, but very little progress on what was supposed to be its central component, the superfund to support Italy and Spain.
- To make matters worse, Greece and Italy were showing little progress on their much needed adjustment programs.
- Lately, we have had important developments in the political sphere, with new governments in Greece and Italy committed to go ahead with much needed reforms.
- These developments provide a window of opportunity to gain control of the crisis but it will need to be accompany by:
- Real progress on the creation of the superfund, ready to buy debt of Italy and Spain, conditional on progress with their reforms or with the creation of an Euro Zone bond;
- Short of the above, an active lender of last resort role of the ECB, which could be exercised through the EFSF.

- The most expeditious way to achieve this is with the ECB upgrading its financial stability objective, acting as a lender of last resort to avoid a major financial and economic crisis.
- If the ECB refuses to be a lender-of-last resort, and if an Euro Zone bond does not fly either, then the only solution left is to accelerate the creation of a larger EFSF. The options here are limited:
  - (1) With further contributions from the most solvent countries in the Euro Zone (given the posture of Germany and the weaknesses of France AAA rating there is not much hope here);
  - (2) With an IMF led program with additional resources provided by emerging countries and other advanced countries.

- As the adjustment programs are going to be contractionary in the short-run, stimulus has to be provided from somewhere else: the ECB and the European countries with strong solvency.
- To avoid further tightening of bank credit, a mechanism also has to be found to facilitate banks' medium term funding.
- In parallel, a framework has to be built to avoid the repetition of similar problems in the future.
  - This could be important to solve political economy issues in Germany, but it will not be of much help to solve the current crisis.
- The task to regain competitiveness in the PIIGS is going to be a hard one.

The road to more competitiveness is not going to be easy

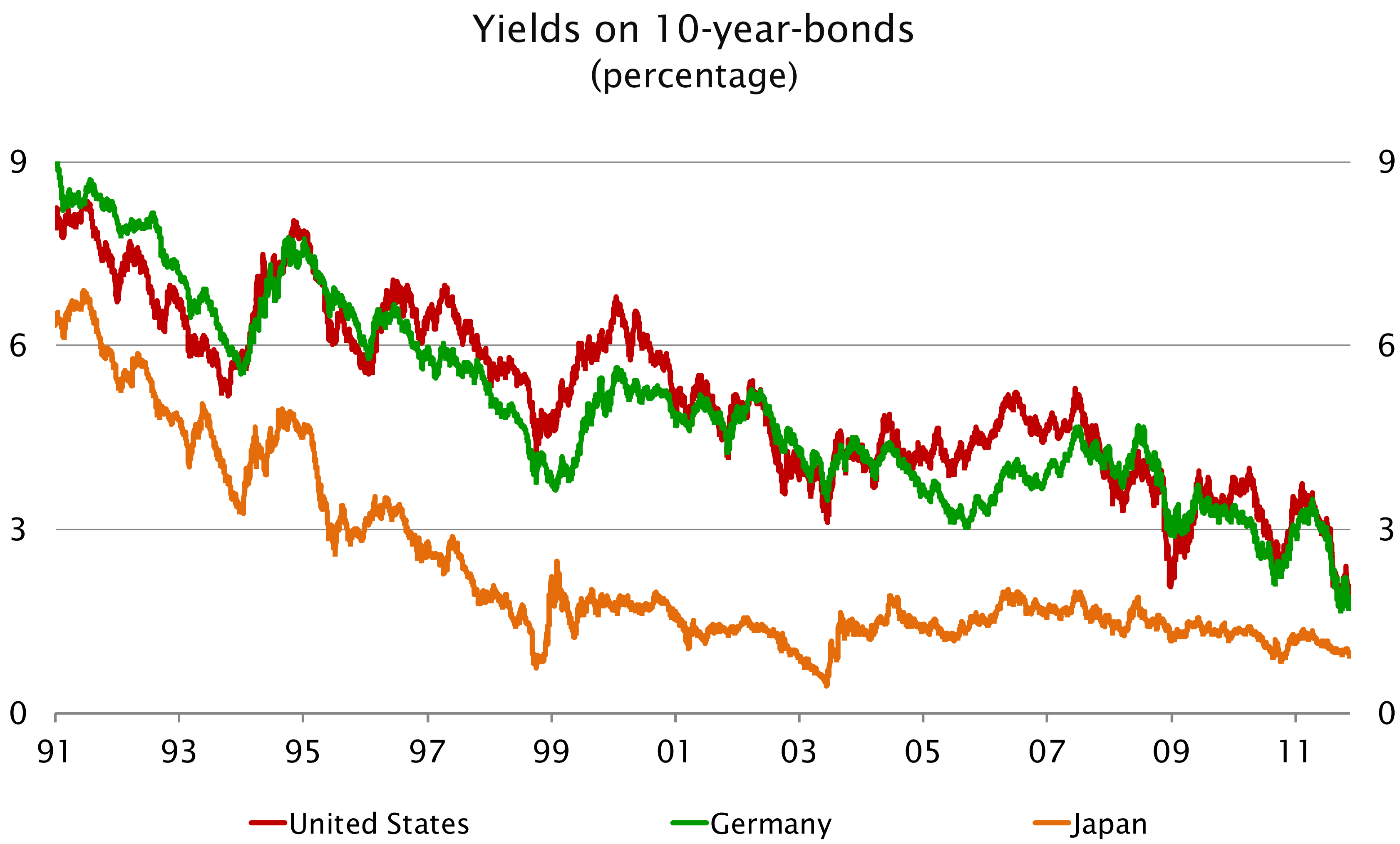
Evolution of Unit Labor Costs
(Index 2000-Q1=100)



Source: OECD Statistics, Main Economic Indicators (database).

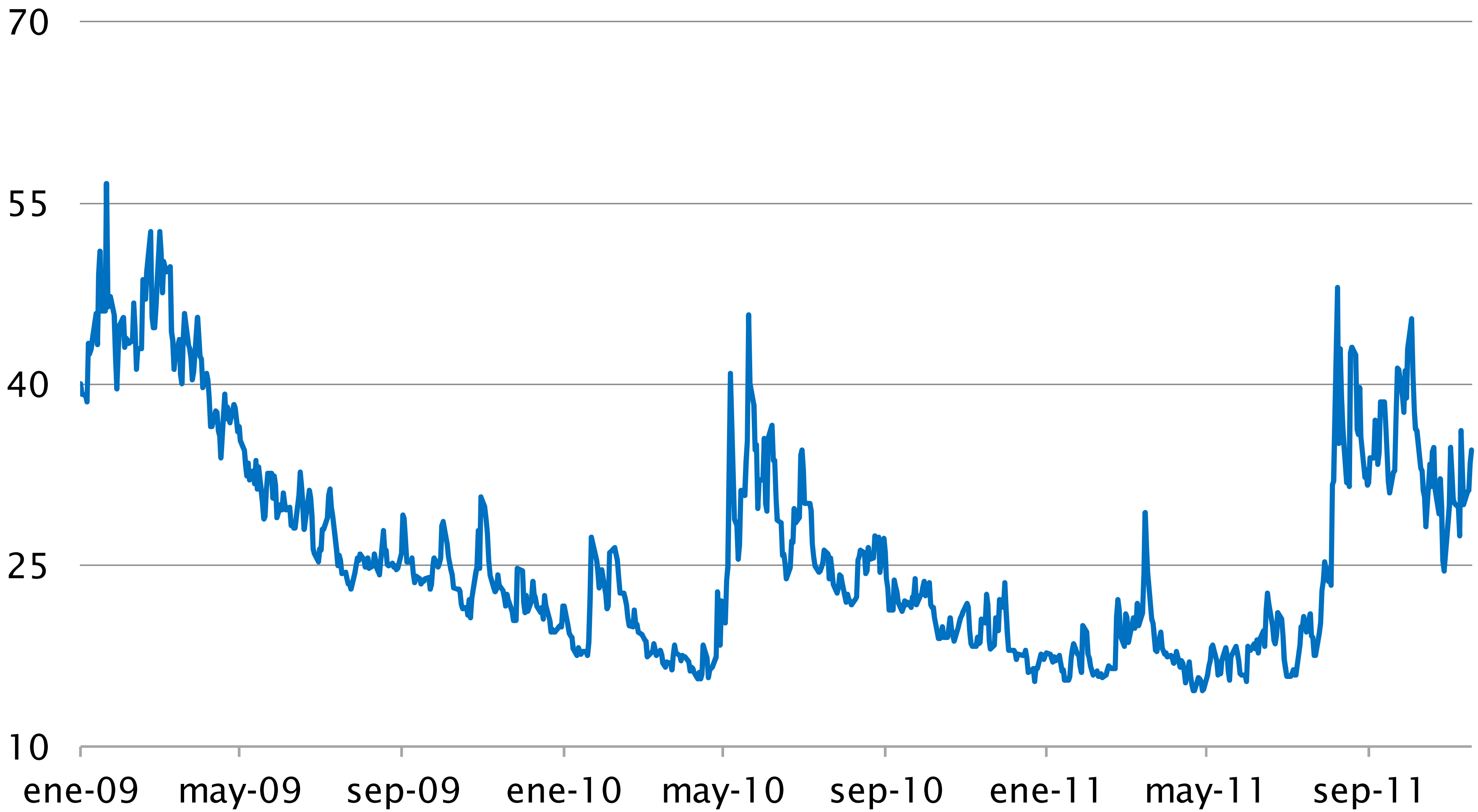
- How can a default come about:
- (1) If due to difficulties in the implementation of its adjustment program Greece ends up with a disorderly default, generating severe contagion effects over the European financial system;
- (2) A failure in the mobilization of sufficient resources to buy debt of Italy and Spain;
- (3) A failure in the implementation of Italy's structural adjustment program.
- In the meantime the situation has become worrisome:
- The spread on Italian and Spanish bonds are closer to 500 basic points;
- The interbank European market is under significant stress;
- European banks have great difficulty in getting bond and dollar funding;
- Higher capital requirements and less access to funding is resulting in a reduction of bank credit; and
- Financial markets have become very volatile, and the flight-to-quality has exacerbated.

Flight-to-quality



Source: Bloomberg, November 17, 2011.

Financial Volatility remains very high (VIX Index)



Source: Bloomberg, November 17, 2011.

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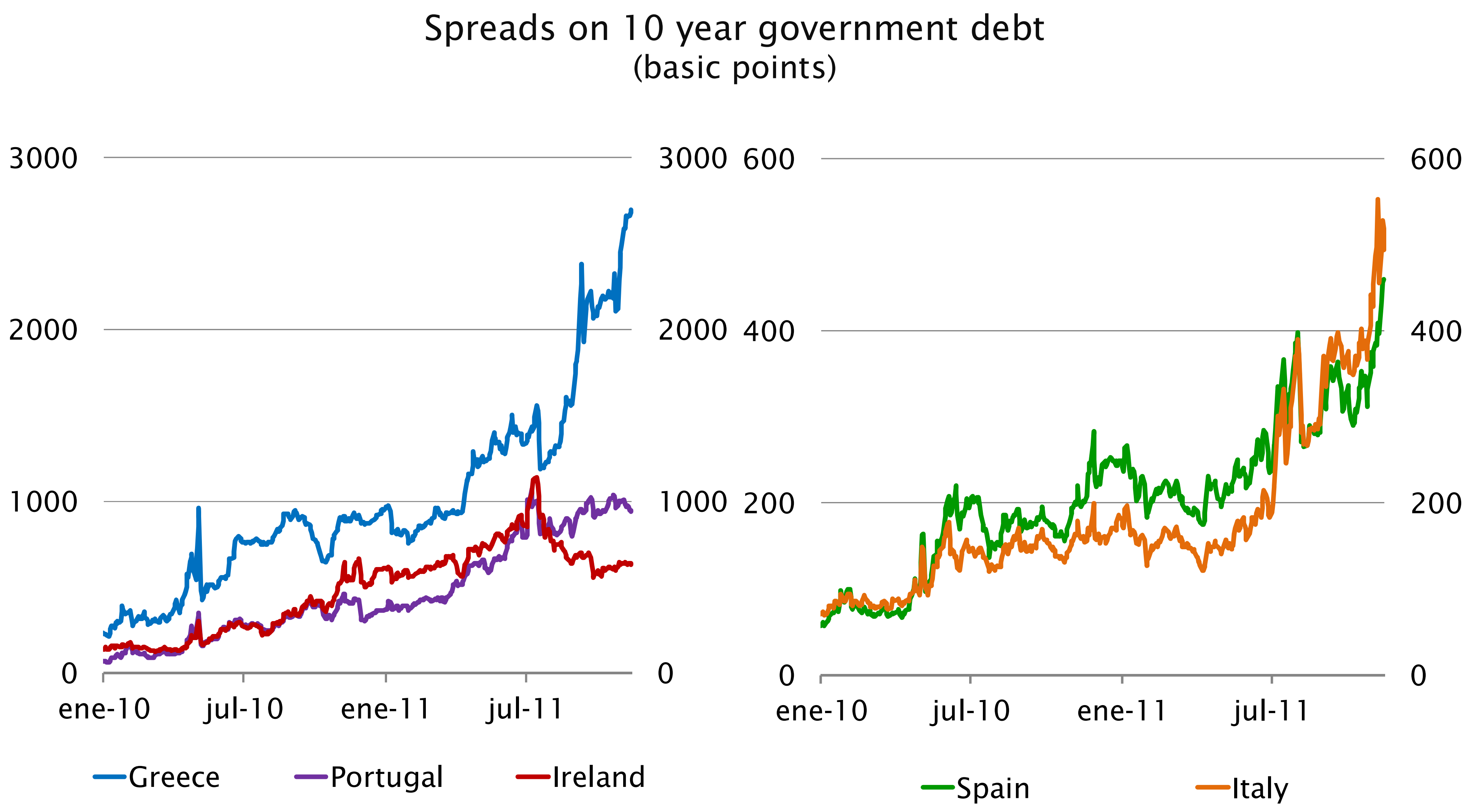
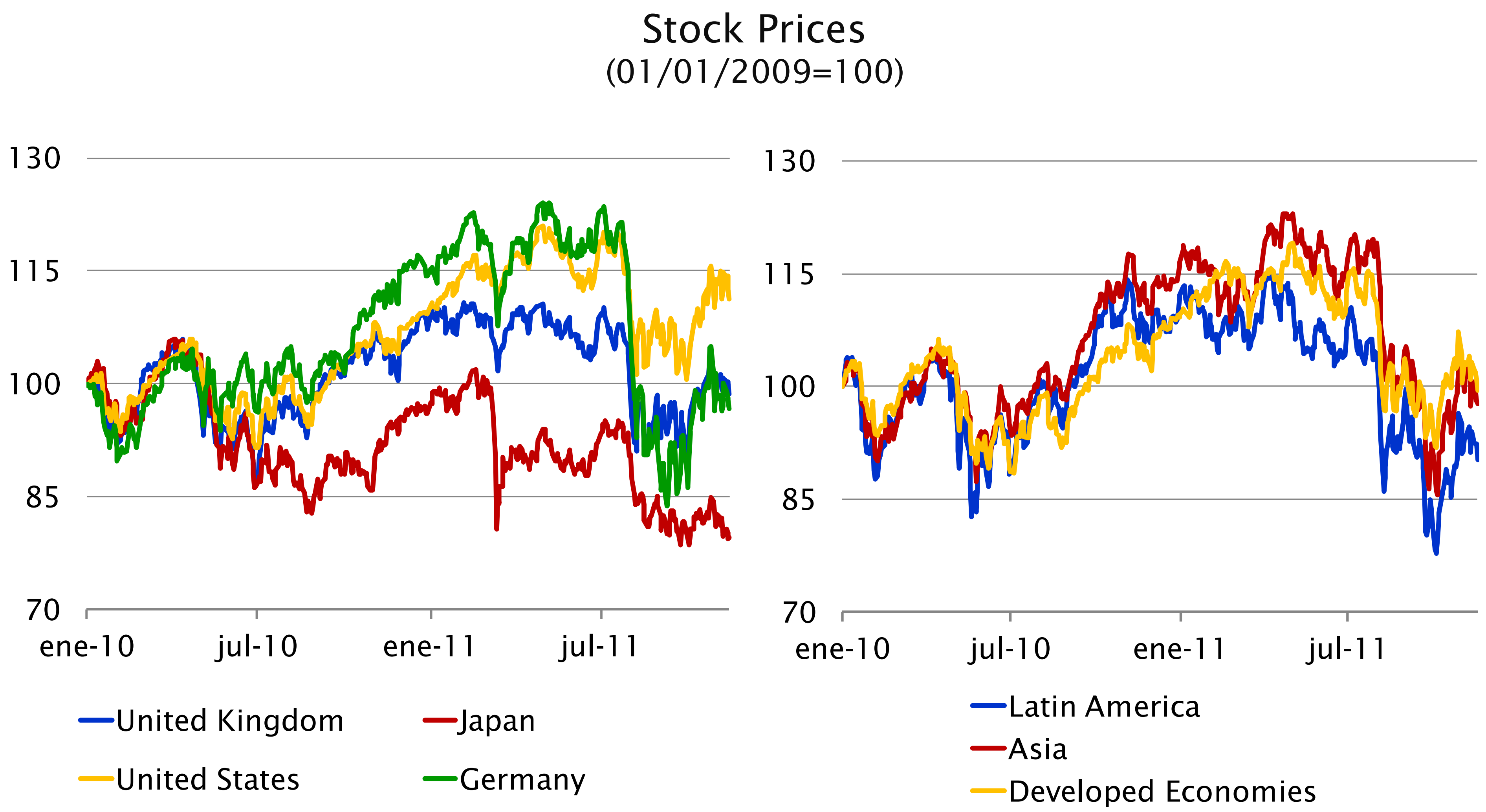
The spreads on PIIGS bonds have reached new highs; Ireland is the exception



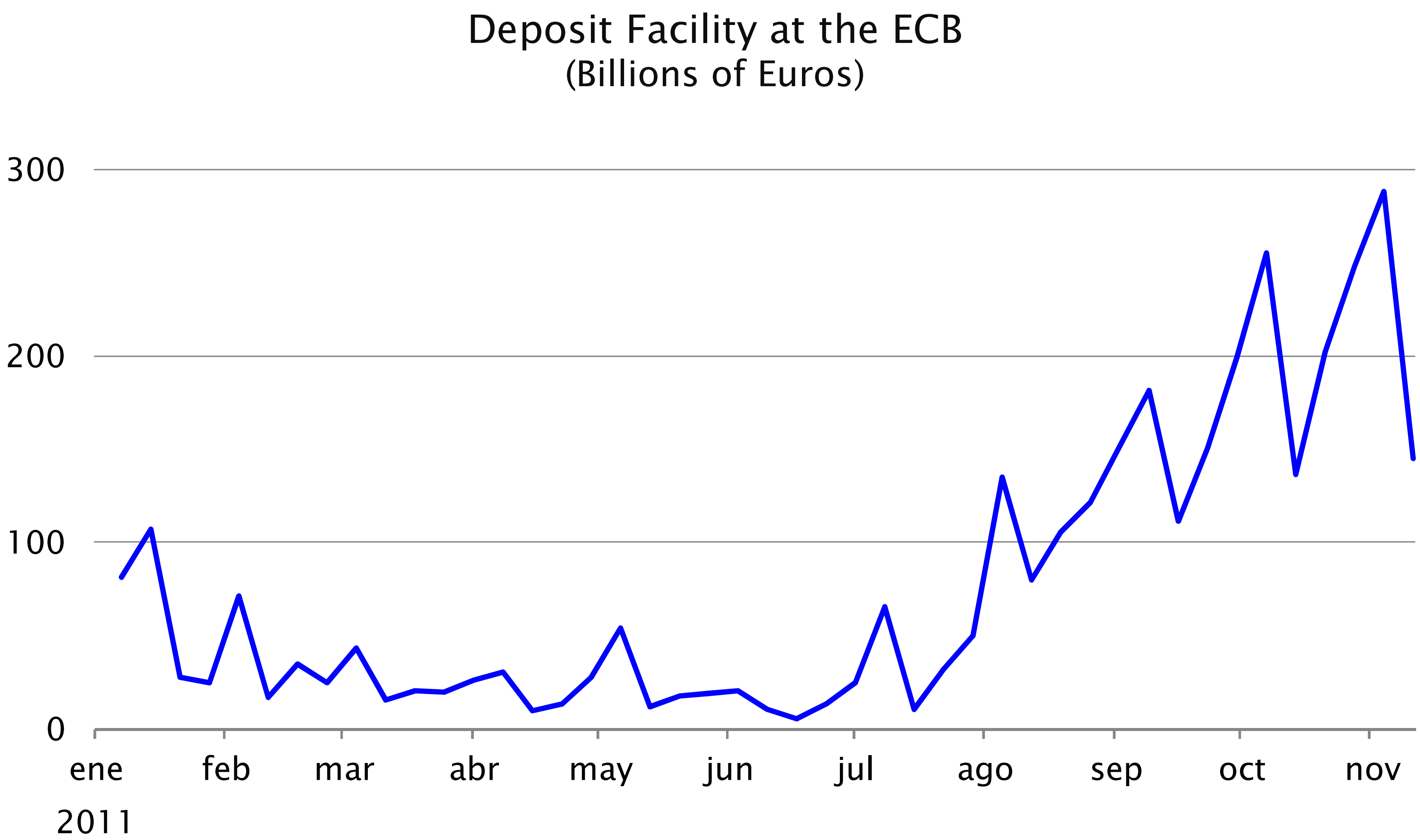
Source: Bloomberg, November 17, 2011.

Stocks prices have suffered, with some recovery at the margin



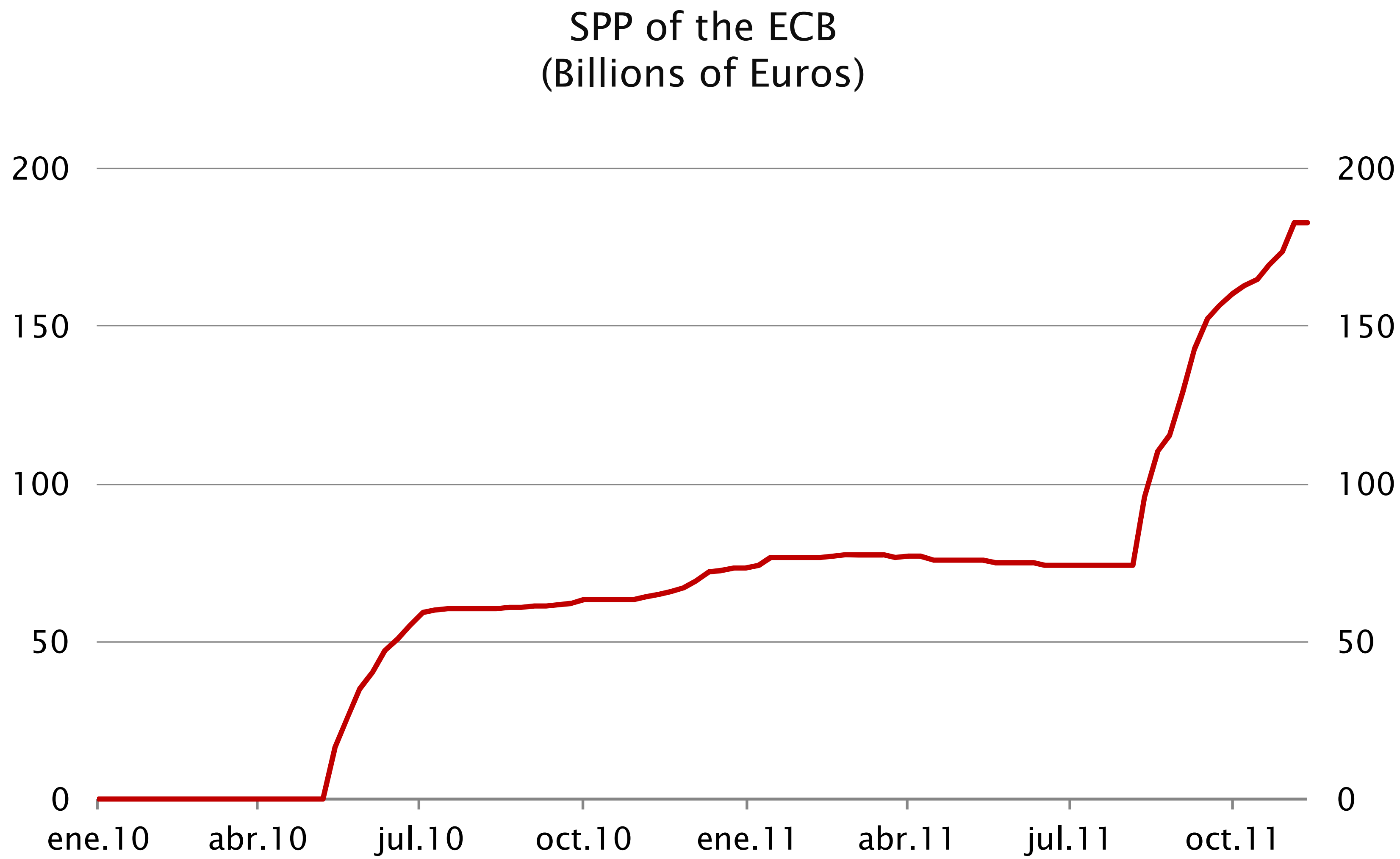
Source: Bloomberg, November 17, 2011.

European Banks have increased their deposits at the ECB



Source: ECB, November 17, 2011.

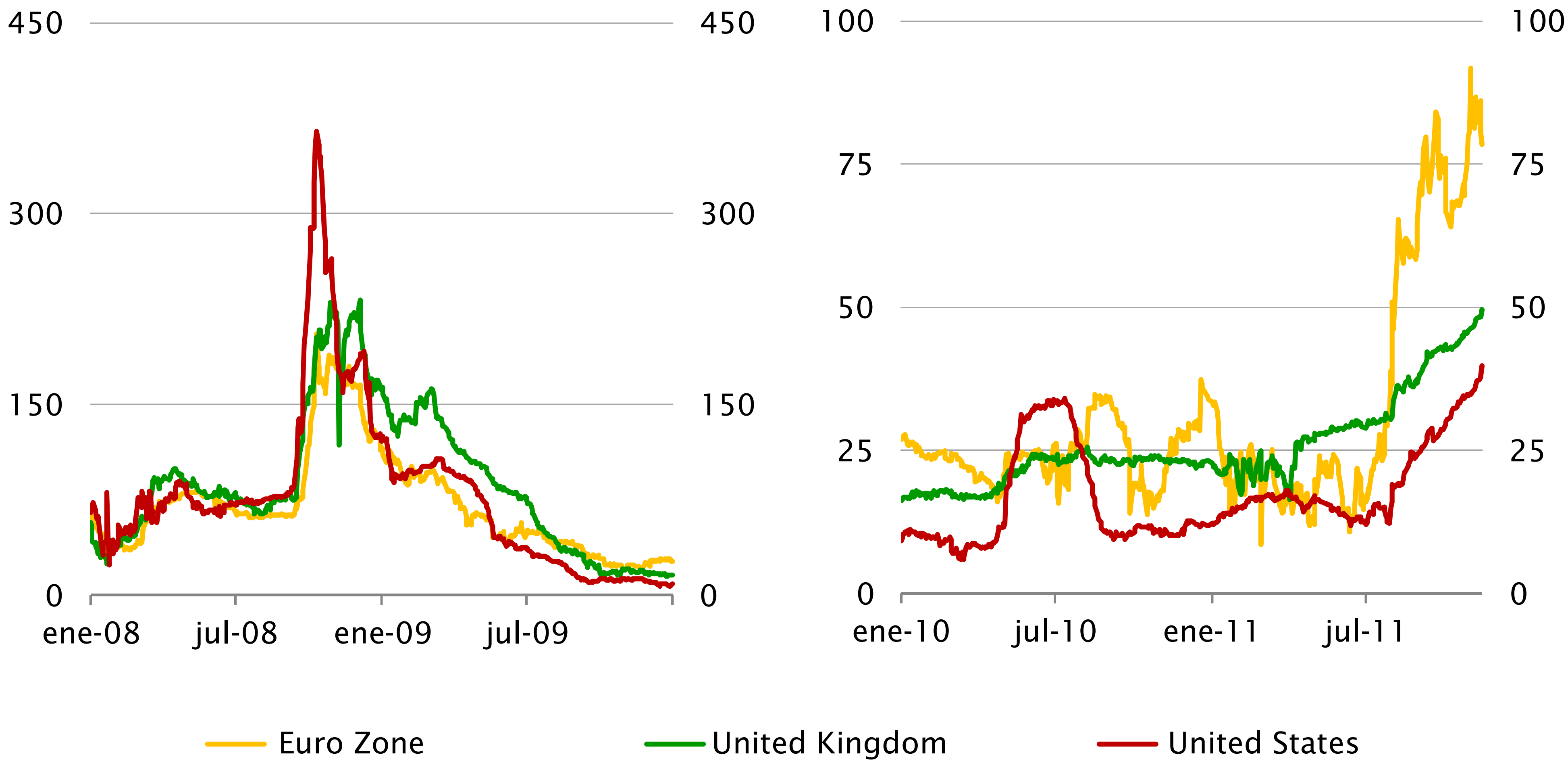
The ECB has increased the purchase of PIIGS bonds



Source: ECB, November 17, 2011.

Interbank markets are under significant stress

Spreads between LIBOR and *Overnight Index Swaps*
(basic points)



Source: Bloomberg, November 17, 2011.

- In the meantime the Euro Zone is heading towards a recession.
  - The GIIPS are suffering the effects of the fiscal adjustment, the higher interest rates and the increase in uncertainty.
  - The rest of Europe is facing the last two effects and the effects of the slowdown in the GIIPS.
- Lately the U.S. economy has been showing more strength that anticipated, but it also is going to suffer the effects of the European crisis.
- With most advancing countries slowing down forget about decupling of the emerging countries.
- However, for primary commodities exporting countries, the most important issue is how will China sails through these rough waters, here one can be a little more optimistic.

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