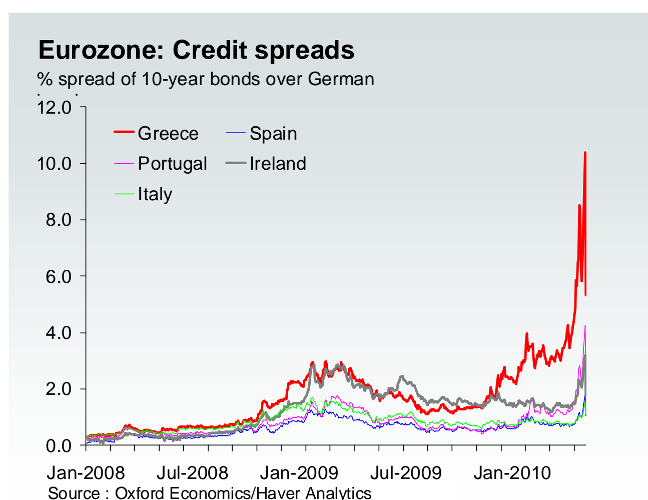
What now for the ‘peripheral’ Eurozone countries?

Summary

Over the weekend the EU put together a large-scale package worth up to €720 billion aimed at stabilising all the ‘peripheral’ Eurozone countries, in the face of mounting contagion risks. This came on top of an earlier financial support package for Greece worth €110 billion. The latest move has brought some relief to bond markets, but major challenges remain. Investors remain concerned about the capacity of Greece to stick to the immense fiscal adjustment needed in the face of a very deep recession and mounting social unrest. With the debt/GDP ratio set to keep rising to almost 150% in the next few years, concerns remain that some kind of debt restructuring or default cannot be avoided. For the other peripherals, too, the outlook remains bleak – while the immediate threat of a collapse in their debt markets has been averted, years of fiscal austerity and slow growth remain ahead.

Support packages bring some relief to markets...

Over the past two weeks the EU has put together two significant packages to support Greece and the other peripheral EU countries. Firstly, in the face of a dramatic sell-off on the Greek bond market, which at one point took two-year yields well above 20%, the EU and the IMF put together a package of financial support worth €110 billion, of which €30 billion is to come from the IMF and €80 billion from Eurozone countries. The package will be spread over three years, and provides sufficient funds to meet Greece’s financing needs – budget deficits and maturing debt – for the next two years. Meanwhile, the ECB has suspended, for Greece, its rules on the minimum acceptable credit rating for debt placed with it as collateral for liquidity loans thus protecting the Greek banking system.



Despite the announcement of this package, markets continued to sell off, and there was growing contagion to other ‘peripheral’ countries such as Portugal, Spain, and Ireland. In the face of this, a broader support package was announced over the weekend.

This package looks impressive both in scale and scope. It features a new €60bn stabilisation facility, which can lend to troubled countries subject to policy conditionality supervised by the EU & IMF plus the creation of a special purpose vehicle (SPV) guaranteed by Eurozone states capable of providing extra resources up to €440 bn. On top of this, up to €220bn of IMF funds and financing could be supplied. Finally, the ECB has also agreed to shore up peripheral country bond markets by directly purchase Eurozone governments’ debt.

The initial reaction on 'peripheral' Eurozone bond markets has been positive. The spread over Greek 10-year bonds over Germany bonds has fallen back to around 5% from 10% at the end of last week, and there have also been significant compressions in the spreads for Spain, Portugal, Ireland and Italy. Nevertheless, spreads remain wide compared to those seen at the turn of the year, especially in the case of Greece which still has 10-year yields above 8% - a level far from compatible with medium-term fiscal solvency. And the euro, which gained significantly on the announcement of the wide-ranging weekend rescue package, has already given up those gains – implying a continuing degree of unease.

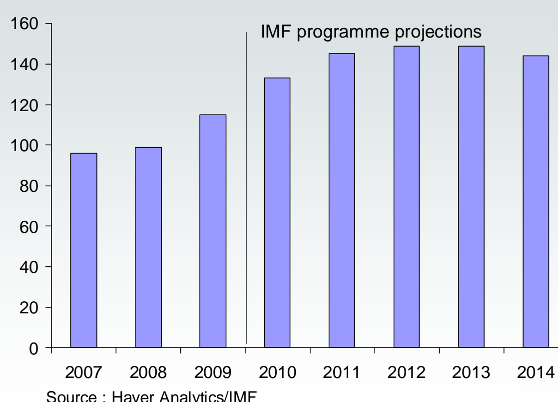
...but major challenges remain...

What lies behind continued market concerns? With regard to Greece, the support package seems to meet many of the concerns expressed by investors over recent weeks. It is substantial in size, and incorporates more realistic macroeconomic assumptions. While previous plans envisaged a relatively mild drop in GDP, this one expects a 4% contraction in 2010 and a 2.6% contraction in 2011, with growth remaining well below trend at 1.1% even in 2012.

Meanwhile, on the fiscal side, Greece has agreed to a programme of fiscal retrenchment that envisages the budget deficit falling from 13.6% of GDP in 2009 to 8.1% of GDP in 2010, 7.6% of GDP in 2011, 6.5% of GDP in 2012, 4.9% of GDP in 2013 and below 3% of GDP in 2014. The primary (non-interest) balance should be positive by 2013, from a deficit of 8% of GDP in 2009.

Perhaps the major concern is that Greece will not be able to stick to the deal. Given the scale of the recession envisaged by the new programme, this concern is understandable. Unemployment, which already soared to over 11% in January, is likely to rise yet further to perhaps 15-16%. Public sector wages and employment are set to shrink sharply. Significant protests against the package are already under way, and there must be a serious risk that in the face of social unrest, the Greek authorities will not be able to 'stay the course'.

Another factor that concerns markets is the debt arithmetic. The IMF/EU deal, while it sees a very large drop in the deficit for 2010 of over 5% of GDP, actually pushes back by two years the point at which the deficit will dip below the Maastricht limit of 3% of GDP. And with much weaker real GDP growth and probable price deflation, this means that the debt/GDP ratio will continue to worsen until 2013, peaking at almost 150% of GDP. This is higher even than the worst ratios seen in Belgium and Italy in the 1990s and implies a massive ongoing burden of interest payments, even if average interest costs drop sharply from current levels. At an average interest rate of 5%, annual interest payments would be 7.5% of GDP, well ahead of nominal GDP growth and requiring Greece to run a large primary surplus for many years to prevent a debt spiral. Based on current market yields, interest costs would be over 12% of GDP.



As a result, markets continue to fear that sooner or later bondholders are likely to take heavy losses with Greece pushed into some form of debt restructuring. This could be in the form either of a 'controlled' writedown, perhaps under the aegis of the IMF (which has supervised similar schemes in e.g. Uruguay and Jamaica) or, in a more extreme scenario, an outright repudiation of debt and perhaps even exit from the Eurozone.

The rating agencies too have been cautious about the new deal, taking a 'wait and see' attitude with regard to Greece's ability to stick to the programme and observing that the challenge of restoring medium-term solvency remains immense. Notably, Moody's announced yesterday that a downgrade of Greece - perhaps to below investment grade - remained possible, despite the recent support packages.

Problems now in all the 'peripheral' Eurozone countries...

Concerns that the Greek problems could spread to other Eurozone states with weak public finances were the driving force behind the announcement of the package agreed by EU leaders at the weekend. So just how bad is the position in these other Eurozone countries? Looking at a series of indicators of vulnerability, none of the other 'peripheral' Eurozone states looks in as bad shape as Greece, but all of them share some of Greece's characteristics.

Table 1 – Key vulnerability indicators for the 'peripheral' Eurozone countries

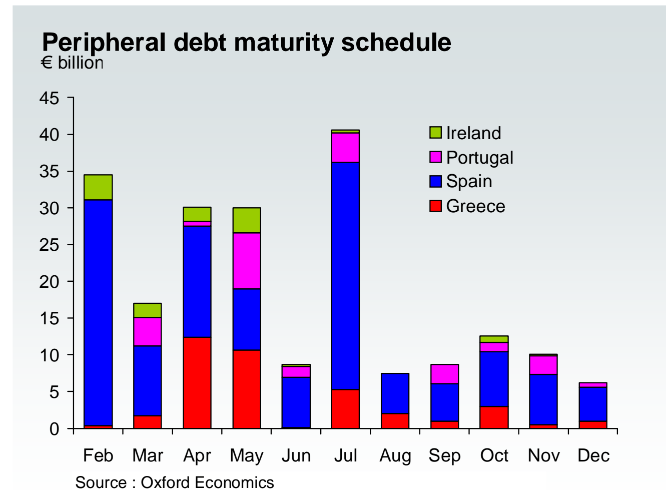
	Greece	Spain	Portugal	Italy	Ireland
Gross public debt/GDP 2010 %	125	60	82	118	77
Primary budget balance 2009, % of GDP	-8.2	-8.5	-3.9	-0.6	-11.6
Interest payments, % of revenues, 2009	13.2	4.5	6.2	10.6	1.6
Gross financing need 2010, % of revenues	74	62	54	59	56
External debt, 2009 % of GDP	170	168	232	116	982
REER January 1999=100	120	129	111	110	129
Current account balance 2009, % of GDP	-11.2	-5.4	-10.3	-3.2	-2.9
10-year bond yield	8.3	4.0	4.8	4.1	4.7
Average GDP growth 2010-2012	-1.1	0.6	1.0	1.1	1.8

Source: Oxford Economics, Haver Analytics   Note: REER=real effective exchange rate, for Greece 2001=100

Spain, which was recently downgraded by S&P to AA from AA+ has a primary budget deficit and external debt load similar to Greece, and its accumulated loss of competitiveness since joining the euro (as shown by the appreciation of the real effective exchange rate (REER)) is slightly greater. But the government debt load, while rising fast, is much lower than in Greece as is the burden of interest payments. Long-term bond yields at around 4% still look modest compared to the other peripherals. Perhaps the biggest concern in the near-term in Spain is that very large debt redemptions are due in July, totaling over €20 billion – if market tensions build again, this could prove a serious pressure point for the domestic bond market.

Portugal is usually seen as the weakest Eurozone member after Greece. On the fiscal side, it looks a less severe case with a much smaller primary budget deficit and a debt/GDP ratio around the Eurozone average. There are major concerns, however, about external vulnerability. The real exchange rate has appreciated more than 10% since the country joined the euro, and the current account deficit is running at over 10% of GDP. Years of large external deficits have also left the country with a very large external debt burden of over 200% of GDP. Portugal was recently downgraded two notches to A- by S&P, with the agency citing 'structurally weak' finances and an 'uncompetitive' economy. Yesterday, Moody's also signaled it would downgrade Portugal over the next few weeks.

Ireland has an even worse primary budget deficit than Greece, but much lower – albeit rapidly rising – public debt. Until recently, the budget issue had been largely addressed by a major fiscal package which won substantial plaudits from investors, but the price action on bond markets in recent days indicates serious concerns have returned. One possible source of this is the country's external position. The real effective exchange rate has appreciated almost 30% since 1999, and the external debt ratio looks massive at almost 1000% of GDP. However, productivity gains have offset some of the exchange rate appreciation and the debt figure is largely the result of intercompany loans linked to FDI and the liabilities of a very globalised financial sector – it is much less scary than it appears.



Finally, we turn to Italy. While Italy was often the weak link in Europe in the past, it currently looks much less vulnerable than the other 'peripheral' states. Fiscal management has been relatively prudent in recent years, so that while the country retains a large government debt of over 100% of GDP, the primary budget is close to balance. The interest burden, while high, remains below that of Greece as does Italy's short-term financing needs. The external picture, while showing some loss of competitiveness in the last decade, does not feature imbalances on the scale of those in Portugal. Italy's lower degree of vulnerability explains why the rise in the country's bond spreads in recent weeks has been relatively muted – Italy is still seen by investors as more 'core' than 'periphery'.

In all the above countries, the large-scale support package announced over the weekend has calmed market nerves. But serious concerns remain. Firstly, the details of the new package remain vague – especially how the proposed SPV, which accounts for the bulk of the impressive headline figure for the size of the package, will work. It is possible that the effective sums on offer prove less than at first appeared to be the case.

In addition, all the peripherals will still have to engage in very severe fiscal tightening, with additional cuts on the way in Spain and Portugal. The Eurozone risks becoming a grim theatre for low growth and grinding competitive deflation. Against this background, the risk of 'austerity fatigue' and an ultimate resort to unorthodox measures cannot yet be ruled out. This fear is likely to keep some risk premium embedded in the long-term yields of all the peripherals for some time yet.

…which could have repercussions beyond the Eurozone

Weak growth in the Eurozone periphery will have knock-on effects on the wider Eurozone as the periphery has been a buoyant destination for exports from the 'core' countries in recent years. Concerns about growth prospects are likely to be exacerbated by the scale of the potential fiscal liabilities building up at the ECB (in the form of its massive lending to peripheral country banks and now purchases of peripheral bonds) and for the 'core' governments who will provide the bulk of the finance for the rescue packages.

The obvious way this will manifest itself is in a weaker euro, and the single currency's prospects may also be dimmed by the likelihood that the financial strain and extra fiscal tightening caused by the recent crisis will mean looser ECB policy than previously assumed. In recent weeks, the euro has been closely correlated with events in Greece, selling off as Greek bond spreads widened. This could now give way to a longer-term downward trend based on a widening growth and interest rate differential with the fast-recovering US.

The sovereign debt crisis in the Eurozone periphery could also have a more subtle negative effect on global growth by undermining faith in government bonds as a 'safe' asset and inducing precautionary fiscal tightenings in countries outside the Eurozone who would prefer not to risk being sucked into the kind of market turmoil recently suffered by Greece. Such moves could offset the policy stimulus previously expected to be a strong growth support this year, damaging the global growth outlook. While the new support packages have averted a rapid spiral toward default which would have been a huge shock for financial markets, the problem of sovereign debt and deficits could continue to weigh on the world economy for some time.