

A question and answer guide to the Eurozone crisis

20 July 2011

INTRODUCTION

The European Union is in the midst of a critical week, one that might just determine the survival of the single currency.

It is our opinion that a default, withdrawal, or ejection of one of the peripheral, highly indebted countries of the Eurozone (or what we refer to as HYPES - see the glossary) would be catastrophic for the European and ultimately Global economy and financial system.

Thus, heading into this crucial emergency summit meeting, our view is that a disappointing or equivocal outcome would be viewed very negatively by the markets and could even hasten the ultimate demise of the Eurozone.

While we do not expect the summit to produce a neat, holistic, immediate resolution, we do wish to see a clear display of unity amongst the European national leaders, and solid commitment by the ECB to play a constructive role. A clear, well-outlined, sufficiently large (in financial terms as well as political scope) proposal that has a highly probable chance of being implemented will be required.

At the end of the day, we feel that the costs which would be incurred as a result of a messy resolution (for example, a default or a banking crisis) are so large that rational actors will recognise this and craft a solution before such an outcome. However, this is not a sure thing; multiple parties with varying short-term incentives must move much closer to a consensus on decisive action – and quickly – than they have done so far.

This Q&A guide therefore, is intended to lay out the many considerations and issues, and identify those which need to be resolved and why.

Our aim is for readers to be sufficiently well-armed to follow the events as they unfold and be able to make informed judgements.

GLOSSARY

BIS: Bank for International Settlements, located in Basel, Switzerland. An international organization that coordinates international regulations, information gathering and dissemination amongst banks in the developed world, and conducts research on international financial issues.


CDS: Credit default swaps. Derivatives contracts which can be bought to protect the buyer against the possibility an entity defaults on its debts.

Core Countries: Those countries in the Eurozone which are not embroiled in both market and official concerns about their fiscal sustainability.

EBA: European Banking Association. An industry organisation whose main function is to coordinate and pursue ongoing development of intra-European bank payment and settlement operations. It was under the auspices of the EBA that the latest round of bank stress tests were performed.

ECB: European Central Bank.

EFFSF: European Fiscal Stability Facility. A special purpose vehicle set up by the Eurozone in May 2010 to fund assistance to the HYPES countries. At present it has a lending capacity €440 billion, made up of contributions from European Union countries.



HYPES: High Yielding Peripheral European States. This refers to Greece, Ireland, Portugal, Spain, and Italy, those countries of the European Monetary Union which have significant fiscal difficulties and have come under severe market pressure, driving their bond yields and borrowing costs much higher than the “core” countries of the Eurozone.

IIF: International Institute of Finance. An industry group with over 420 global members which aims to foster international banking cooperation, lobby on behalf of its members and promote and support research on issues of international banking and finance.

PSI: Private Sector Involvement. The notion that in addition to national governments, and by implication their taxpayers, that private sector entities (banks, insurance companies, other investors) bear some of the burden of any bailout, default, or resolution.

SMP: Securities Market Programme. A facility set up by the European Central Bank to provide liquidity to banks in the Eurozone who cannot access wholesale markets at acceptable interest rates. In return for this liquidity provision, the ECB demands collateral from the banks involved.

Troika: The International Monetary Fund, European Union and ECB, the three principal organizations involved in bailouts and assistance programs for HYPES countries.

1. What is the current status of the European debt crisis?

Although the Eurozone crisis has alternately intensified and relented at various times since January last year, last week saw unprecedented market pressure.

Italy, the continent's third largest economy, saw the market shun its bonds to the point where spreads between Italian ten year bonds and German bunds of the same maturity rose to over 6% (Source: Factset). While Italy has always been highly indebted, throughout most of the crisis, it had been seen as safer than some of the other HYPES. While its debt is quite high, Italy's deficit had been lower than many other HYPES in recent years, and well over half of Italian government bonds held by the public were done so domestically. (Source: BIS). Yet concerns about the budget it proposed to parliament last week, as well as contagion from across the Aegean Sea put Italy firmly in the spotlight last week. With Italy coming under such pressure, European minds have become much more focussed.

To illustrate the intensification of the crisis last week, the table below compares the spreads on ten year bonds in the HYPES to German bunds of Friday the 8th of July and Monday the 18th July 2011.

Spreads between selected countries' ten year bond yields and German ten-year bond yields (% per annum)

	Greece	Ireland	Portugal	Italy	Spain
8 July 2011	13.56	10.00	10.75	2.44	2.83
18 July 2011	15.07	11.10	11.47	3.31	3.64
Change in ten days (b.p.)	151	110	72	87	81

SOURCE: Bloomberg, July 2011

The following table shows the widening of Credit Default Swaps (CDS) spreads over the same period (Friday the 8th of July and Monday the 18th July 2011).

Five-year CDS spreads for selected sovereign debt (basis points)

	Greece	Ireland	Portugal	Italy	Spain
8 th July 2011	2172	920	1040	251	316
18 th July 2011	2568	1196	1214	331	385
Change in ten days	396	276	174	80	69

SOURCE: Bloomberg, July 2011

In addition to market fears surrounding Italy last week, European leaders have recognised the need to craft a second bailout package for Greece in order to prevent a default in that country. At the moment there has been a lot of noise from various protagonists but no consensus has emerged.

2. What's next?

A special summit has been called in Brussels for Thursday the 21st of July for heads of state to address the issues above and primarily the Greek package. (See below for a discussion of the key issues).

At one point, German Chancellor Merkel said she would not bother to show up if there wasn't already a preliminary agreement - she backed off that stance last night. (*Financial Times*, 19th July 2011)

Der Spiegel, the influential German magazine reports that professionals in the German finance ministry are working round the clock to come up with various solutions and scenarios, estimates of their costs, etc. (*Der Spiegel*, 18th July 2011)

We view this summit as one of the defining events in the history of the single currency, perhaps in the European Union. Failure to come up with solid agreement and a unified front and a strong plan will probably be seen as real disappointment by the markets and could set off serious shockwaves throughout Europe and the world.

3. What are the key issues to occupy the summit?

The main issue that will be on the agenda in Brussels is the form of the second rescue package needed by Greece.

The Germans and other key core countries in the Eurozone are insisting that some form of Private Sector Involvement (PSI) be included in any package. This means that private sector investors who hold Greek debt must share the costs of any bailout package.

This could be done either by getting the private sector to agree to exchange their existing holdings of Greek bonds for new bonds at longer maturity and lower, less onerous, interest rates. This "Rollover Option" has been suggested for a few weeks now, and the primary advocate of this approach is France.

Another option under consideration would be for outstanding Greek bonds to be bought at current, highly discounted market prices, by some central entity such as the EFSF. In another version of this proposal, the EFSF would lend directly to Greece at below market interest rates and the Greeks would in turn buy back their original debt and retire it. This, option, known as the "Buyback Option" has been floated by the Germans and others. This would be a much more severe form of PSI, as current bondholders would be paid market prices which are well-below par.

Whatever option is chosen, the point remains that finally the EU leadership has recognised what we, and others, have been saying all along: Greek debt, under current circumstances, is ultimately unsustainable and in the absence of some sort of restructuring, will be defaulted.

The ECB has been adamant (we discuss in more detail below) that it will not accept any form of restructured debt from any country as collateral for short term interbank loans under its securities market program (SMP). Expect this issue to be a major sticking point in Brussels.

4. What is the ECB's role in this and what position are they taking?

Since the crisis began some 18 months ago, the ECB has been providing extraordinary liquidity support to several HYPES countries via their Securities Market Program (SMP). As HYPES sovereign debt came under such pressure, and the local banks in these countries were seen as risky counterparties, they have been effectively shut out of European wholesale funding markets. To prevent interbank liquidity from drying up completely and therefore dooming the local banking systems, the ECB has stepped in to provide this support. In return, they have accepted government bonds as collateral. These bonds have been steadily downgraded and many are no longer investment grade, but the ECB continues to accept them, providing an important lifeline to the domestic banking sectors of the HYPES.

Recently however, the ECB, especially President Trichet, has asserted that it will not accept any restructured debt as collateral. Since restructuring is important to resolve the crisis, this represents a dilemma for the European leaders. This position puts the ECB and German Chancellor Merkel at odds with one another, as the ECB's stance will make any restructuring (or, in the jargon "selective default") difficult to pursue. This is an important and difficult issue that must be resolved this week in Brussels.

Others on the ECB Council have been less strict. Lorenzo Bini Smaghi has indicated some forms of restructuring might be acceptable, and his colleague Ewald Nowtmy said that some forms of restructuring would only be considered as short term in nature and therefore possibly acceptable. (*Financial Times*, 19th July 2011)

In the absence of ECB concessions on this point, other methods of maintaining interbank liquidity in the HYPES are possible. Under the ESFS, a fund exists that might be used to lend to the interbank markets and others have suggested that charging all European banks a levy would fund a pool of monies that might be available for this purpose.

Regarding monetary policy, the ECB has made a clear distinction between the SMP, which is in place to ensure liquidity in wholesale funding markets, and its interest rate policy, which is intended to address inflationary concerns across the Eurozone as a whole. The ECB has been raising rates this spring and summer, and all indications are that it will continue to do so. We do not view rising short term interest rates in the Eurozone as a meaningful contributor to the larger problem of the sovereign debt crisis in the HYPES.

5. The EBA published the results of the long-awaited stress tests over this past weekend. How did that go?

Not well. The scenarios tested did not include any notion of a sovereign default by one of the HYPES, hence did not address the principal worry of the markets.

As it was, 82 out of the 91 banks tested "passed" the tests, in that under adverse scenarios envisioned by the stress test exercise, they managed to retain assets equal to or above 5% of core tier 1 capital.

Nevertheless, the market appeared to treat the stress tests as bad news since, on Monday alone, European financial stocks fell by 3.3%. (Russell Global Indexes, Developed Europe, Financial Services in local currency).

One useful element that did come out of the stress tests, however, was that for the first time detailed balance sheet data for all the participating banks has become publically available. This is a new level of transparency that had been missing in the past and allows independent analysts to make their own assessments based on their own scenarios.

6. What is the situation for European Banks?

Part of the reason a default in the Eurozone would be considered so catastrophic is that so much of HYPES debt is held by banks outside of the HYPES themselves. Any write down or haircut of, say, Greek debt, would be felt by German and French banks. The interrelatedness of these holdings makes all countries in the Eurozone (and some outside of it) at risk if any of the HYPES cannot make it through the crisis.

European bank stocks have lost over 10% year to date, in large part as a result of these fears. (Russell Global Indexes, Developed Europe, Financial Services in local currency).

The banks are obviously then important stakeholders in any discussion to resolve the crisis. They are represented by the Institute of International Finance (IIF), an umbrella organisation that lobbies on behalf of large financial institutions throughout the world. The IIF is currently meeting with the Troika to make sure their interests are represented.

The situation with the banks is one of the keys to the problem, and any solution that is developed must include an eye on the banks.

7. Since spreads on ten year bonds for HYPES are at or near record highs, does this mean these countries have to pay this interest rate to borrow?

No. These spreads are reflecting yields on bonds already issued and trading in secondary markets. The governments that issued them do not have to pay the market interest rate, they have to pay the interest rate on any new tenders they bring to market. Rising yields (falling prices) of bonds on the secondary market mean that these assets are seen as “hot potatoes” for which there is little demand, and those who do wish to purchase them will only do so at a discount.

For example, on Thursday last week, the Italian treasury auctioned off nearly €5 billion in 5-year and 15-year notes and paid interest rates of 4.93% and 5.90% respectively. This is their true borrowing cost. It is still quite high.

In another example of how yields in the primary market are also rising for HYPES, on 19th July, Spain auctioned off nearly €4.5 billion in 12-month and 18-month bills at interest rates of 3.702% and 3.912% respectively. Just one month ago, a Spanish auction of notes of the same maturity secured borrowing at rates of 2.695% and 3.26% respectively. It is clear how much borrowing costs have risen for the HYPES in a short period of time. (Source: Bloomberg).

This is an important concern. Because as interest rates rise when markets fear the solvency of a borrower, that borrower's solvency gets further undermined by the new interest rates. This is the self-reinforcing cycle that the HYPES have found themselves in since January 2010, and is why their debt problems are becoming more and more unsustainable.

8. If the euro is to survive what needs to be done?

We have long argued that a three-pronged solution is needed for the Euro to survive, and due to the costs that a disorderly exit and/or default would imply, this is the most likely outcome.

- First the rescue facility already in existence, the EFSF, must be increased to have more firepower to deal with steadily deteriorating conditions across the HYPES.
- Second, given that the current debts of at least some of the HYPES are, in our (and increasingly the markets' and the policymakers') minds, unsustainable, some acceptable, well-organised restructuring must be enacted, probably with some degree of PSI.
- Third, the countries that have got into trouble must continue the painful but necessary process of adjustment, bringing their fiscal houses in order and reshaping their economies to be more competitive.

We often refer to these conditions as a “three-legged stool.” While we don’t know the exact details of any of these legs, and taking the analogy further, we don’t know how they will look, what their design will be, or even what material they will be composed of, we feel strongly that these legs must exist.

We think this week is crucial because the acknowledgement of the need of these three legs as well as a good idea of their form will have to be forthcoming to prevent further descent into uncertainty and in their absence an ugly outcome.

9. Why wouldn’t one or more HYPES countries withdraw from the Eurozone, and/or why wouldn’t one or more of the core countries do so?

While on the surface a solution of this type might seem attractive, when looked at more deeply, this would not be an effective solution, and we reckon would be more costly to all involved than any form of the bailouts suggested above.

Furthermore, there exist no legal mechanisms in the treaties and other agreements that have set up the Eurozone, the ECB and the entire single currency system for any withdrawal or ejection from the arrangement by one of its members. That having been said, treaties have been abrogated in the past and a country may decide that its national interest is better served by breaking an agreement than adhering to one. We just do not think that given current realities, this would be a desirable outcome. (Note, under the Treaty of Lisbon, the European Council can enact extraordinary measures by unanimous consent of all countries in the EU, and a country can leave the European Union via qualified majority vote of all member states).

First of all, the sheer physical and logistical difficulties and costs associated with reintroducing a new currency in a country, virtually overnight, would be staggering. When the Euro came into existence in January 1999, it did not exist in physical form until January 2000, and even then, national notes and coins and Euro notes and coins existed in parallel for six months with the former being slowly phased out over time.

All contracts, domestically and internationally, which have been agreed to and are denominated in euros would have to be settled in the new currency, but it is likely that this new currency would be significantly depreciated in the case of a withdrawal from the Euro.

Euro-denominated debt would still be valid in the absence of any restructuring, so a country which leaves the zone would have to still repay it, but at a new, disadvantaged exchange rate, so no debt relief would be forthcoming, short of a default.

Domestic bank holdings and other assets, initially denominated in Euros would have to be converted to the new currency and would likely be worth less. To prevent this erosion of wealth, savers and other asset owners would likely “rush for the exits” precipitating a disastrous bank run. To prevent that, the central bank could impose capital controls, but this would be a severe action, and would likely be illegal under any EU law, and would serve to shut that country out of capital markets for years to come.

What interest rate and monetary policy would the central bank adopt in a newly-withdrawn or ejected country? What exchange rate mechanism (floating, fixed, semi-flexible, etc) would be established, and what kind of credibility would this likely much weaker currency convey, both internally and externally?

If one country lead the way out of the zone, investors would fear that others will follow. The contagion that would ensue would likely be catastrophic.

In the core, foreign assets held by core investors would be written down, corporate and financial balance sheets would contract and the credit crunch that would follow would impart serious pain to the domestic economy.

Given that German trade is 60% oriented to Eurozone countries, a new exchange rate which would make core country goods and services much more expensive would significantly crimp the export sector and the real economy in the core would also suffer adversely.

For these reasons, an exit from the single currency – by either one of the HYPES or one of the core – would be costly and probably disastrous for all when international contagion effects are taken into

consideration. We therefore do not think this will happen in anything but the most extreme circumstances.

10. In the event of default, or other “messy” outcome, would this crisis have any effect on the rest of the world?

If one of the HYPES defaults abruptly, or the Eurozone breaks up, we have little doubt the world will be engulfed in a calamity of Lehman-like proportions.

Fears about sovereign debt are already present in the US, which is facing its own 11th hour fiscal mess, and the UK, which is addressing its own problems. These fears will intensify and it is conceivable that investors will look askance at all countries with significant fiscal imbalances.

The banking system globally is exposed to sovereign debt from the HYPES, either directly or indirectly through counterparties, and the shockwave would affect financial systems outside of Europe.

The real economies would also suffer severely as Germany, which conducts two thirds of its trade with other European Union countries, would see a huge hit in their export markets. Even China, geared so much to western demand and facing internal challenges itself, could succumb if a recession were to result in the west.

Financial markets would also suffer from general risk aversion in the event of an ugly outcome. We have seen already that markets have been weak and wary, and this would probably only get worse.

On the other hand, a successful outcome would probably lead to a relief rally across the board, and under our central scenario of decent but moderate global growth and strong corporate fundamentals, markets could quickly regain their footing.

11. How are the political forces lined up?

Within the HYPES, politicians are facing significant domestic pressures. Several years of austerity have plunged many of them into recession and the populations and bodies politic are showing dwindling patience with these measures. In some places, this euphemistically-called “adjustment fatigue” is leading to civil disorder. Leaders in these countries are therefore counting on some relief, hopefully by the end of this week.

Internationally, the populations of these countries, and even some of the leaders themselves, are losing patience with EU-wide failure to come up with decisive measures. Anti-Euro feeling is understandably high, but in our opinion not welcome.

In the core countries, leaders are having trouble getting their citizens to swallow the notion of committing further tax dollars to bailout programs to their peripheral neighbours. At the moment the billions already committed appear to be “money sent down a rat hole”, as the crisis has only got worse in recent weeks, and any future “passing of the hat” has deep-seated opposition. Some countries’ governments have already succumbed to this opposition, and other leaders are playing a delicate game of balancing domestic and European-wide responsibilities.

We have always felt that the Euro and its creation was principally a political process, and doubtless its resolution will require the same courage and commitment from current politicians. The hope is that the turmoil of the last weeks will impose the discipline of the market, and this week leaders will address these outstanding issues effectively.

12. What to watch?

On Wednesday, 19th July, there was a preliminary meeting of deputy finance ministers, senior central bank figures, and treasury officials of the EU in preparation of the leadership summit the next day.

Expect more statements from and positions to be staked out by protagonists, and trial balloons floated. There may even be leaked information and partial disclosure of plans from the Wednesday meeting, but we do not think anything clear will emerge until Friday.

By Thursday evening, expect some statements of intent, the broad shape of some provisions and some discussion about what the key sticking points are. We would not be surprised to see the work continue through the weekend. If the news is downbeat on Thursday night or Friday morning, strap yourself in for an ugly Friday and don't expect to have a fun weekend as we wait for events to unfold next week.

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