

# Europe's Fiscal Folly

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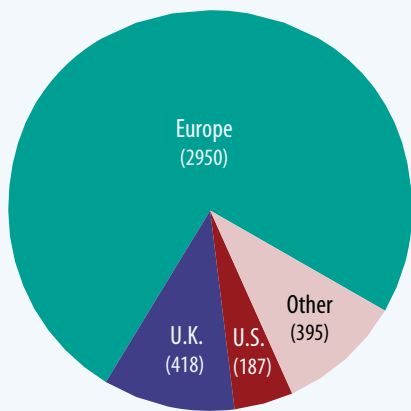
After months of dithering, European leaders assembled a comprehensive plan to backstop troubled Euro Area countries on May 9. Increasing contagion worries which hammered the euro along with global equity markets amid increasing signs of credit strains forced Europe into action. The newly formed European Financial Stabilisation Mechanism (EFSM) expands an already existing European Union balance of payments facility by €60 bln to €110 bln, and creates a three-year €440 bln special purpose vehicle, which will see the IMF provide an additional €250 bln, all of which will go towards loans and guarantees.

Tightening liquidity among European banks likely prompted global financial and monetary officials to have flashbacks of 2008 when credit markets froze globally as interbank lending dried up. Discussions among global leaders aimed at avoiding a repeat of 2008 pushed Europe towards the weekend announcement. Uncertainty about bank exposure to European sovereign debt was breeding mistrust and starting to impair credit flows. As of 2009Q4, European banks held US\$2.95 trln in PIIGS (Portugal, Ireland, Italy, Spain, and Greece) public and private debt. By comparison, the U.K.'s exposure was \$418 bln, U.S. was \$187 bln and Canada's was a tiny \$471 mln (*Chart 1*). Much of that is likely comprised of sovereign and bank sector debt. A selloff in those assets would have hit bank capital levels hard at a time when they are still recovering from the recession and financial crisis. Lending standards have only just started to ease in the U.S. and Europe, and a new crisis would undo much of the progress made over the past few months.

The €750 bln EFSM may on the surface appear excessive, but a massive show of force was necessary to prove to markets that the European Monetary Union (EMU) was no longer taking a piecemeal approach to solving the crisis. PIIGS bond yields plunged on the announcement, narrowing spreads versus German bunds after a huge run-up in the prior week (*Chart 2*). The mechanism significantly lowers near-term default risk for most Euro Area countries, though Greece will likely remain a concern.

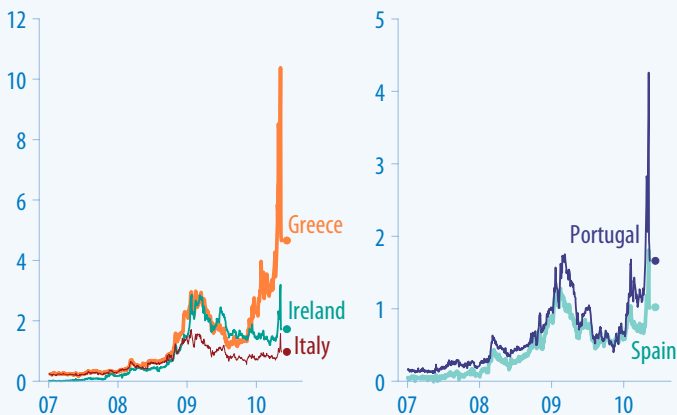
Greece's €110 bln package is unaffected by the new facility, and should be enough to fund borrowing needs for the next two to three years. Greece was the focal point for the trouble, and that's unlikely to change. The

**CHART 1**  
**PIIGING OUT ON DEBT**  
Foreign Banks' Exposure to PIIGS Debt (US\$ blns)



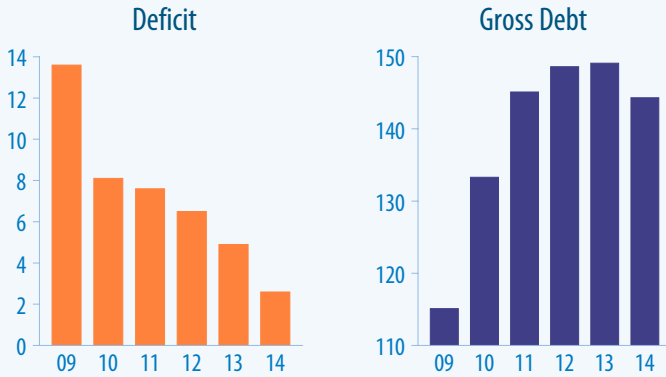
As of 2009:Q4  
Source: BIS

**CHART 2**  
**WORTH THE RISK?**  
10-year Spreads vs Germany (as of May 13, 2010)



**CHART 3**  
**UNSUSTAINABLE DEBT LOAD**

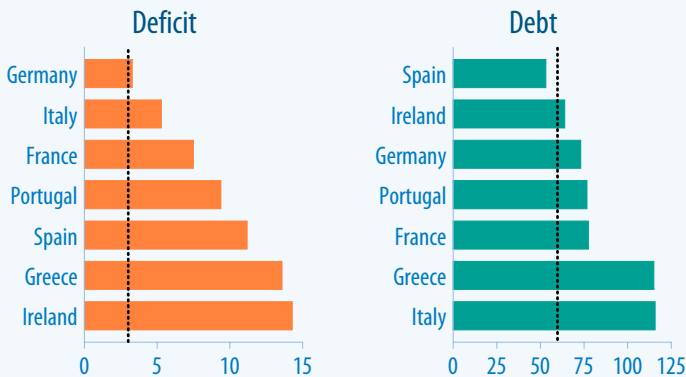
Greek Economic Forecast (% of GDP)



Source: Greek Government

**CHART 4**  
**TIME TO FOLLOW THE RULES**

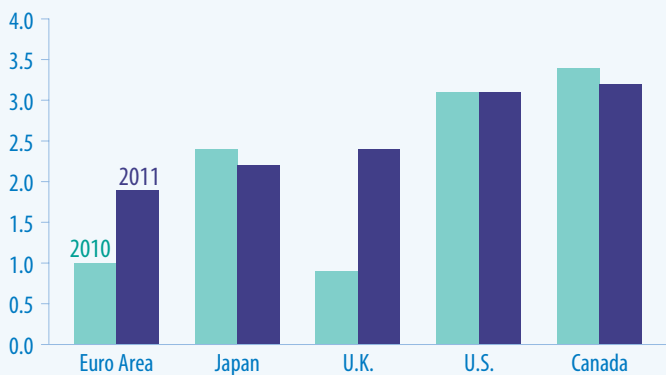
2009 (% of GDP)



Dotted line represents Maastricht Treaty limits: 3% deficit, 60% debt

**CHART 5**  
**FISCAL OUTLOOK SHACKLES GROWTH**

Real GDP Growth (ann % chng)



BMO Capital Markets Forecast

government is planning sizeable spending cuts along with tax hikes to close a gaping budget deficit that stood at 13.6% of GDP in 2009. The plan is to bring the deficit down to 2.6% of GDP in 2014, though debt-to-GDP will still rise to 144% (Chart 3). Assuming a 5% interest rate on the debt, Greece would have to run a primary budget surplus of 7.2% of GDP just to pay off the interest and balance the budget. Such a large primary surplus likely isn't achievable, making Greece's financial position unsustainable even with the €110 bln package. As such, barring another bailout, we expect Greece to default in the medium-term, perhaps as soon as the EMU/IMF loan package runs out if markets aren't charging reasonable rates by then. Default will probably entail a restructuring of debt, with lenders taking a sizeable haircut. That's where the EFSM comes into play. The facility provides a backstop for other countries if they are shut out of credit markets, or if jitters return when/if Greece restructures, which should limit the risk of contagion.

The EFSM means more than just a backstop for Euro countries. It shows that Euro Area members are firmly committed to keeping the euro intact. That commitment is a likely first step towards a fiscal union. Without tighter fiscal rules, it's probable that the Euro Area would find itself back in crisis mode before long. Euro members are going to face tighter policing of fiscal rules, which until now have been blatantly ignored. Expect stricter enforcement of the 3% deficit limit, with meaningful penalties if a country runs over without permission. In addition, the 60% of GDP debt limit should also see stricter enforcement (Chart 4). An increasing role for the European Commission in Brussels is likely in the cards. One possibility is that governments may need to obtain each other's approval when forming budgets. Part of this process will involve losing some sovereignty to the Euro Area, which is essential to ensure everyone follows the rules.

With nearly all of Europe facing steep budget cuts, lightening the debt load is going to be a difficult task. Lower government spending coupled with higher taxes means growth is going to remain sluggish in the region for at least the next couple of years. That makes budget cuts even more important, as countries won't be able to rely on growth to lower their debt-to-GDP ratios (Chart 5).

**CHART 6  
UNDER ATTACK**

Euro (US\$/€)



While markets greeted the announcement very favourably, the euphoria wore off quickly, particularly for the euro, as worries about implementation risks and a lack of details came into focus. Germany could have some difficulty passing the new mechanism into law, after German Chancellor Merkel's ruling coalition lost a state election and could lose their majority in the upper house of parliament. The German populace was already up in arms about lending further to Greece, so news of this package is unlikely to be greeted warmly despite the initial positive market reaction.

Portugal appeared to be the next country in the market's crosshairs, but the EFSM and European Central Bank bond purchases have alleviated that pressure for now. Portugal's fate remains clouded, with the speed of fiscal tightening

balanced against slow growth and a rising debt load. Assuming interest rates don't become too onerous, it's possible Portugal could pull through without any aid. Borrowing needs of €10 bln to €12 bln for the rest of 2010 will be an ongoing test, but the recent rally in government bonds is encouraging, as was the country's successful 10-year bond auction on May 12.

**Bottom Line:** The EFSM has stopped the bleeding in Europe and likely prevented a crisis in the near term. However, the lack of follow-through in the euro's rally post-announcement speaks volumes about the market's faith in the region and its concerns about growth. In order for the euro to remain viable in the longer term, an extended period of significant fiscal consolidation is needed. In addition, fiscal policies must be more closely monitored and fiscal rules made enforceable. Europe can no longer afford to put off its fiscal problems, markets just won't allow it and the euro may not survive it.

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