

# Monitoring Europe's Credit Crisis

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Scarred by the subprime credit crisis, investors remain wary of Europe's debt woes. Since early April, when Greece's fiscal follies took centre stage, global equities have posted double-digit declines and credit spreads have widened. Although the announcement of a massive European stabilization fund has steadied the euro and equities, rising credit spreads in some European countries suggest investors remain nervous about sovereign default risks. Failure on the part of governments to corral deficits would send global equities skidding again and credit spreads soaring, and the resulting decrease in household wealth and slowing in bank credit could derail the global recovery. However, we expect governments to implement severe austerity measures, mollifying fears. In this case, continued global growth (outside of Europe) and relatively low interest rates should provide a supportive backdrop for equities and

corporate debt. Still, with the stakes set high, monitoring the direction that Europe's credit crisis will take in coming months should be at the top of every investor's to-do list.

**As a starting point, investors should be alert to the government's deficit-cutting actions and the public's response.** While the countries most at risk—Greece, Portugal, Spain and Ireland—plan to reduce their deficits to more sustainable levels in coming years, the time for talk is over, and aggressive spending reductions, public sector cutbacks and pension reform must be implemented before investors let down their guard. Greece is scheduled to receive a second dollop of funds from the EU/IMF in late summer but only if it complies with certain fiscal criteria, and failure to do so could lead to default. Encouragingly, a recent interim review by the EU/IMF/ECB suggested Greece's program is currently on track. In the meantime, unions in several countries plan to strike this summer, disrupting the important tourism industry. The degree of public discord is an important barometer of whether governments are likely to keep their deficit-cutting resolve. If expected peaceful demonstrations devolve into anarchy, the odds of an orderly resolution of Europe's crisis would diminish.

**Credit markets are a bellwether of financial crises.** Investors began demanding a higher premium on Greece's sovereign debt in November following news that its budget deficit was larger than previously thought, and well before its problems became front page news in April. (Chart 1). The May 10<sup>th</sup> announcement of the €750 billion

CHART 1

## PAYING THE PRICE

10-year Government Bond Yield Spreads – 2009-2010 (ppts)

Greece versus Germany

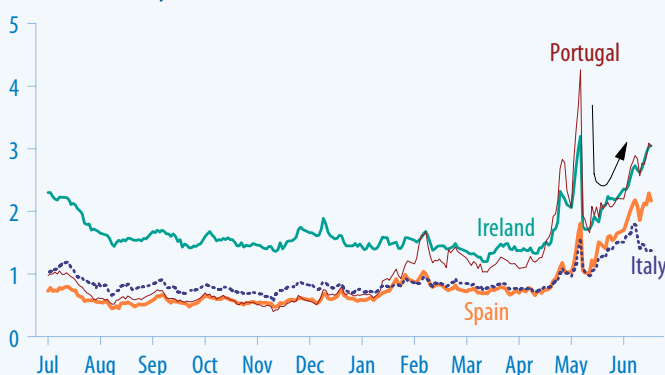


CHART 2

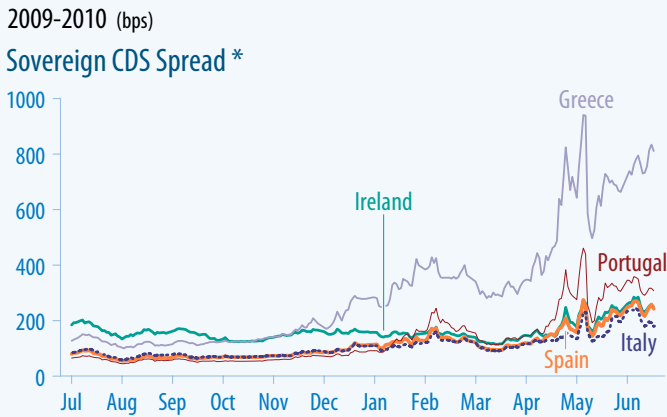
## TEMPORARY REPRIEVE

10-year Government Bond Yield Spreads – 2009-2010 (ppts)

Versus Germany

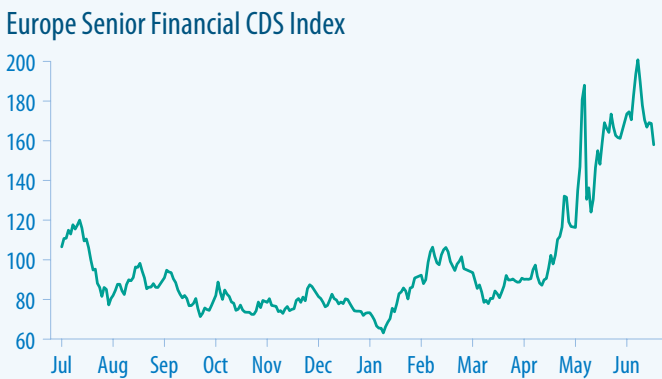


**CHART 3**  
**RISING COST OF INSURING GOVERNMENT DEBT...**  
 2009-2010 (bps)



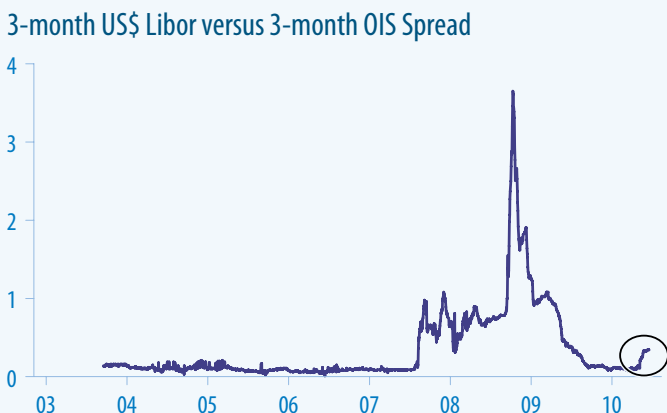
\* represents cost in thousands of dollars to insure \$10 million in bonds

**CHART 4**  
**...AND BANK DEBT TOO**  
 2009-2010



Source: Markit Group

**CHART 5**  
**DON'T BANK ON IT**  
 (pppts)



European Financial Stability Facility to backstop sovereign debt, together with the ECB's decision to purchase government bonds, has relieved some of the pressure in debt markets. However, outside of Italy, **sovereign credit spreads** have resumed widening (*Chart 2*). In fact, Spain's spreads are the widest since the euro was formed amid concern that its shaky savings banks (which account for half of the financial sector), sagging property markets and 20% unemployment will compromise the government's deficit goals. Further increases in sovereign spreads would suggest lenders are losing confidence in the fiscal outlook. Similarly, further sustained increases in **sovereign credit default swap spreads**, which measure the cost of insuring against government default, would portend trouble. While CDS spreads have steadied recently, those for Greece and Portugal remain elevated (*Chart 3*), with the implied probability of Greece defaulting within five years set at nearly even odds (versus just 3% for the U.S.).

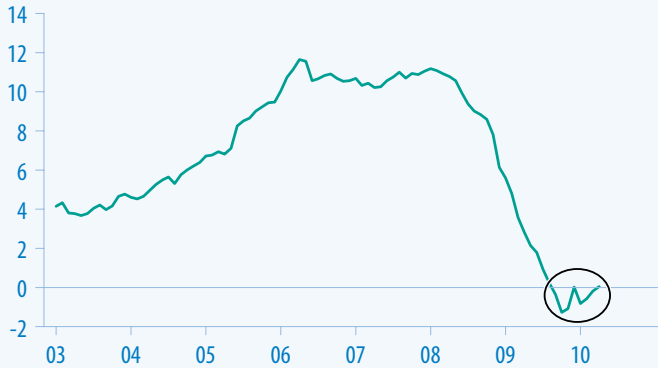
European banks have the most to lose if a country defaults. The Bank for International Settlements found that Euro area banks, as of late 2009, held \$1.6 trillion of private and public debt issued by Spain, Greece, Portugal, and Ireland. French and German banks held the vast majority, at almost \$1 trillion. Investor nervousness over bank exposure has raised the **cost of default insurance for European banks** to near-record highs and well above that for U.S. and Asian banks (*Chart 4*). Snubbed in private markets, Spain's banks have had to borrow record amounts from the ECB. Accordingly, there is keen interest in the forthcoming release of "stress test" results to see how well capitalized Spain's banks are in the event of future write-downs.

As with the subprime crisis, banks are looking at each other with increased suspicion. European banks are not sure which counterparties have the most exposure to sovereign default, and consequently are demanding higher premiums to lend to each other. The **three-month US\$ Libor to overnight index swaps spread**—the rate that banks borrow dollars from each other in the London wholesale money market less a measure of the expected fed funds rate—has tripled since April (*Chart 5*). Although this spread has stabilized recently and remains well below subprime crisis levels (largely because the Fed reopened dollar swap lines with several major central banks to meet

**CHART 6**  
**LENDERS ON STRIKE**

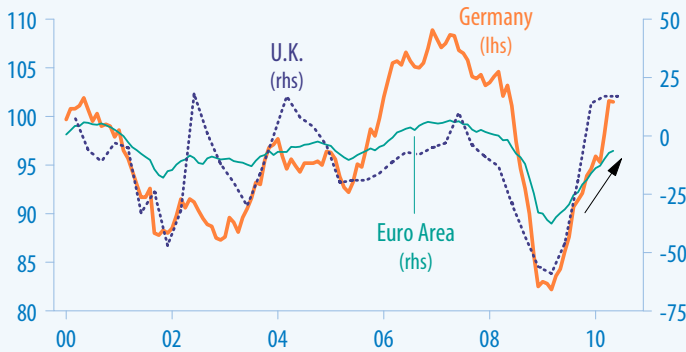
Euro Area (y/y % chng)

Financial Institution Loans to Private Sector



**CHART 7**  
**STILL CONFIDENT**

Business Confidence



Germany = IFO Business Climate Index (s.a.) Euro Area = Industrial Confidence Indicator (s.a.)  
U.K. = Optimism about Business Situation Compared to 3 Months Ago (percent : s.a.)

**CHART 8**  
**BAROMETER RISING... AGAIN**

United States

St. Louis Fed Financial Stress Index \*



\* positive number denotes above average level of stress in financial markets

the strong demand for dollars), a further sharp increase would indicate growing stress in the interbank market.

**Investors should monitor European bank lending and business confidence.** Bank credit has just started to turn up again after contracting through most of last year, but a renewed slump could severely undermine the recovery (Chart 6). So far, there are few signs of trouble in business confidence surveys (Chart 7).

**Investors should also be alert to signs of contagion in the world's biggest economy, the United States.** Wider credit spreads and weaker equity markets have resulted in some deterioration in financial conditions. The **St. Louis Fed's weekly Financial Stress Index**, based on 18 indicators, shows a meaningful increase in financial stress to above average levels (Chart 8). However, the current level pales in comparison with the subprime credit crisis peak, and implies softer, rather than negative, growth. In addition, American business surveys have yet to flag delays in hiring or spending due to Europe's problems.

**The Bottom Line:** While some recent developments are encouraging, until the all-clear flag is waved over Europe's fiscal crisis, investors will need to closely monitor fiscal actions and public reactions, sovereign credit and CDS spreads, financial stress indicators, bank lending and business surveys to assess whether the situation is getting better or worse.

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