BNY MELLON
GLOBAL MARKETS

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Eurozone: Starve the Cold or Feed the Fever?

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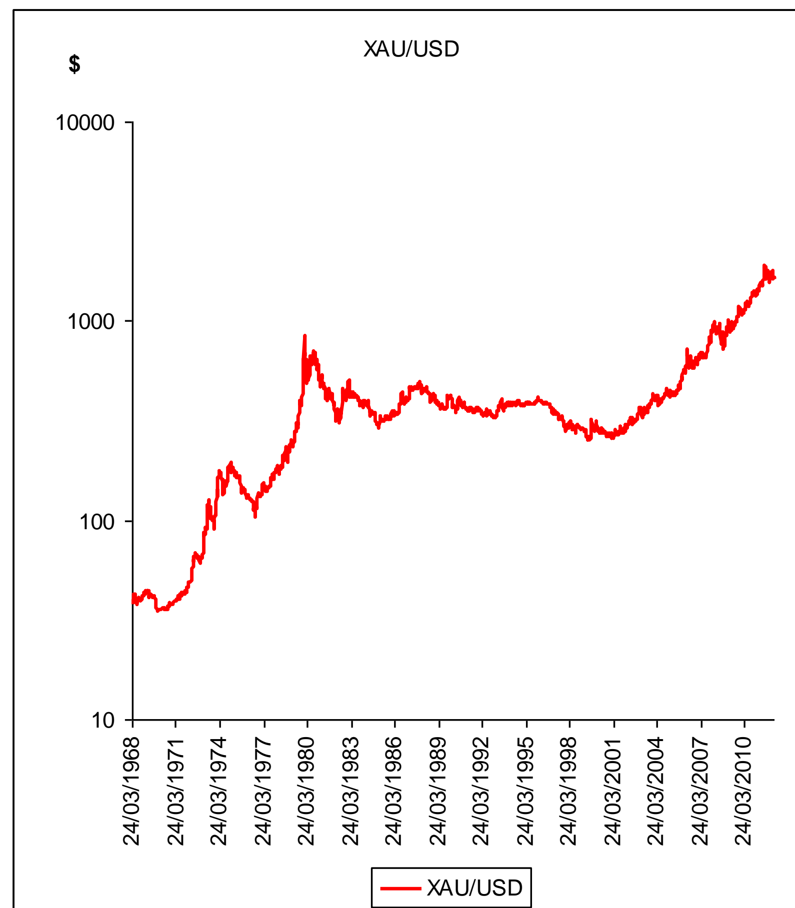
What is the Euro-zone?

- An economic and monetary union:
  - A trade bloc which is composed of a common market and customs union with a monetary union.
  - It is not a debt union
  - It is not a fiscal union
  - It is not complete economic integration
- As a result
  - Monetary policy of the zone is the responsibility of the European Central Bank
  - There is no common representation, governance or fiscal policy for the currency union.
- The primary means for fiscal coordination are the Broad Economic Policy Guidelines. These are not binding.
- Members are expected to respect the Stability and Growth Pact, which sets agreed limits on deficits and national debt, with associated sanctions for deviation.

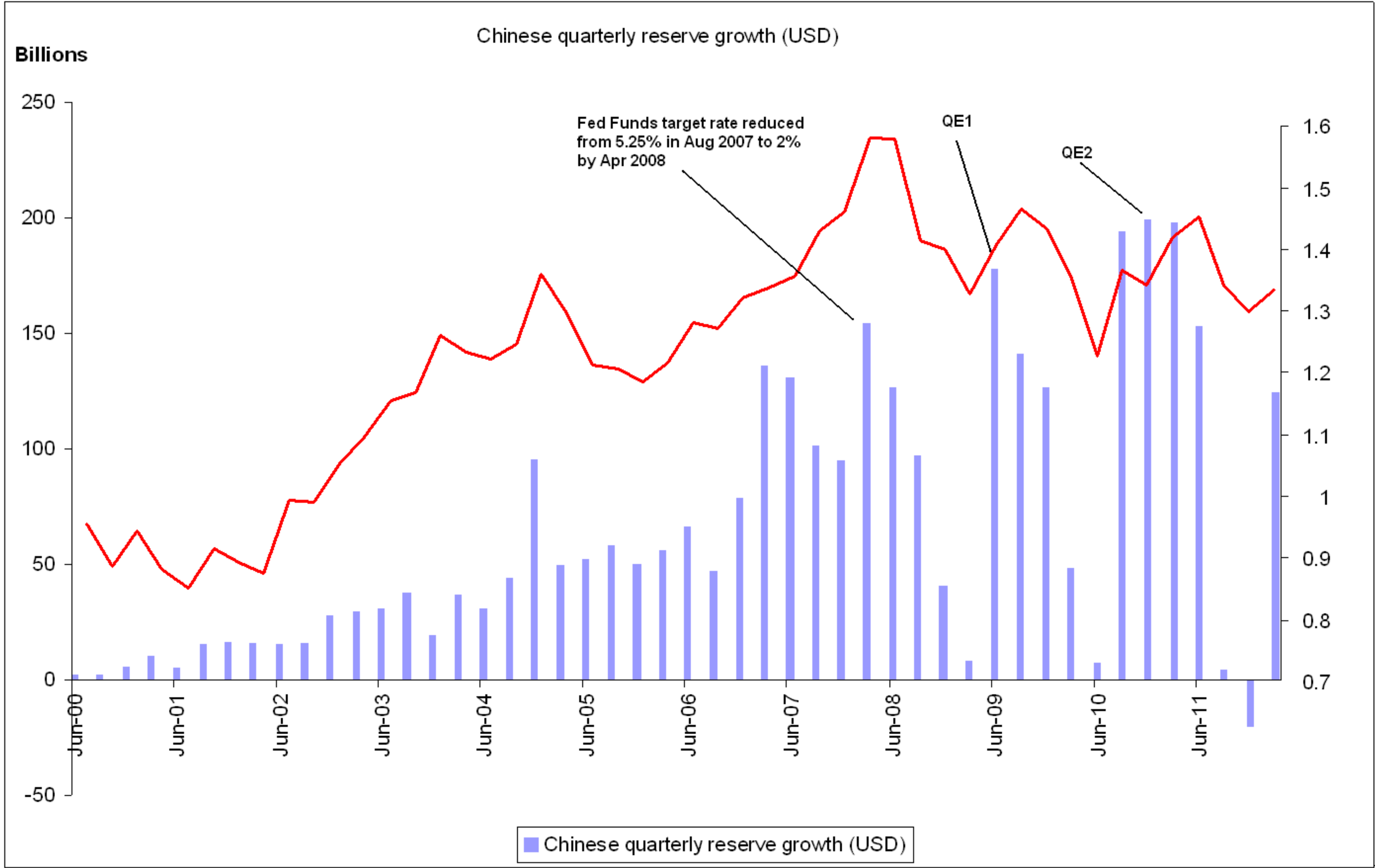
The post 2002 external environment

- Since start of 2002 the average Fed Funds target rate has been 1.96%. The average level of headline inflation has been 2.44%.
- US was not the only nation pursuing an aggressively easy monetary policy. In March 2001 Japan introduced policy of quantitative easing.
- US, Japan and China also involved in extended battle over currency policy.
- Investor behaved in a rational manner and bought:
  - Currencies supported by central banks with a strong, anti-inflationary stance.
  - Precious metals such as gold
  - Equity markets in nations with currencies linked to the USD that were likely to benefit from export fuelled growth
  - Commodities (such as oil) that were likely to be in demand as export booms in China (and elsewhere) continued on.

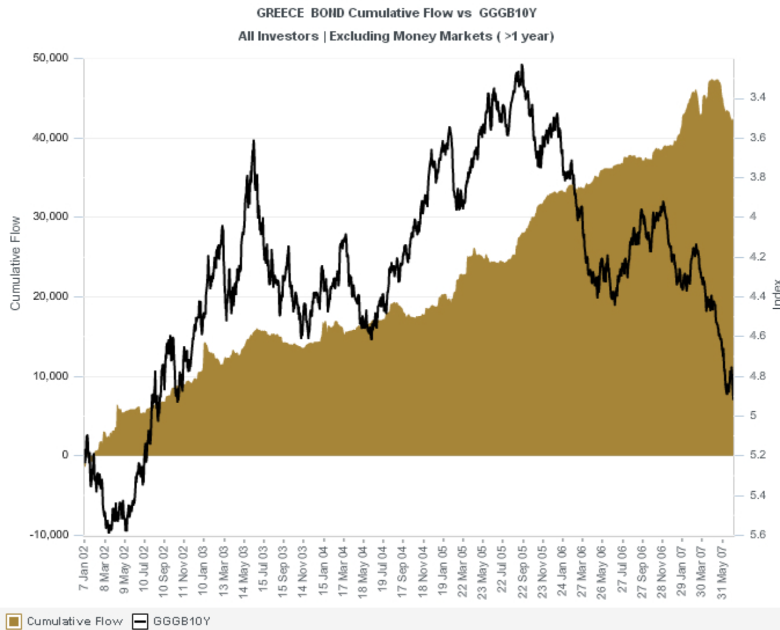


Central bank behaviour

- According to the IMF, in the first quarter of 2002 total FX reserves globally stood at just over USD 2 Trn. Out of this amount the Fund knew how USD 1.57 Trn of reserves had actually been allocated with 71% being held in USDs and 19.7% in EURs.
- By the end of last year total FX reserves had jumped to over USD 10.19 Trn while the USD now only represented 62% of known holdings. The EUR's share, in contrast, now came to 25%.
- The main growth in the reserves of emerging and developing economies, rising from USD 824 Bn to USD 6.8 Trn. The USD moved from representing 74% of known holdings to 57.7%. The EUR's share, in contrast, moved from 19.3% to 27.4%.
- China has seen the most dramatic growth in its reserves, rising from USD 227 Bn at the start of 2002 to USD 3.305 Trn at the end of March of this year.
- Although we do not know how the split of these reserves has changed over time, Dow Jones calculates that the proportion held in the USD has fallen from 74% in 2006 to just 54% by the summer of last year.



Chinese quarterly reserve growth (USD)
Billions
250
200
150
100
50
0
-50
1.6
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
Fed Funds target rate reduced from 5.25% in Aug 2007 to 2% by Apr 2008
QE1
QE2
Jun-00
Jun-01
Jun-02
Jun-03
Jun-04
Jun-05
Jun-06
Jun-07
Jun-08
Jun-09
Jun-10
Jun-11
Chinese quarterly reserve growth (USD)


GREECE BOND Cumulative Flow vs GGGB10Y
All Investors | Excluding Money Markets (>1 year)
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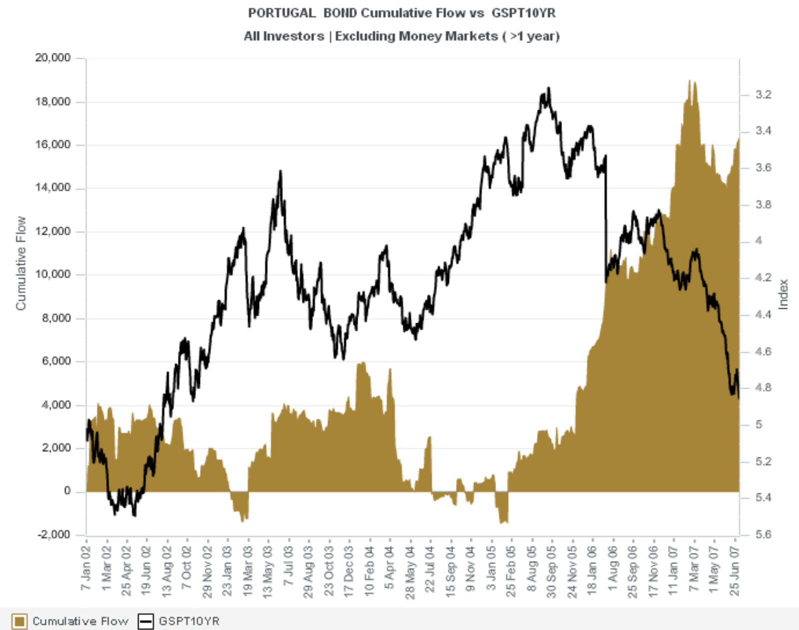
Cumulative Flow
GGGB10Y


PORTUGAL BOND Cumulative Flow vs GSPT10YR
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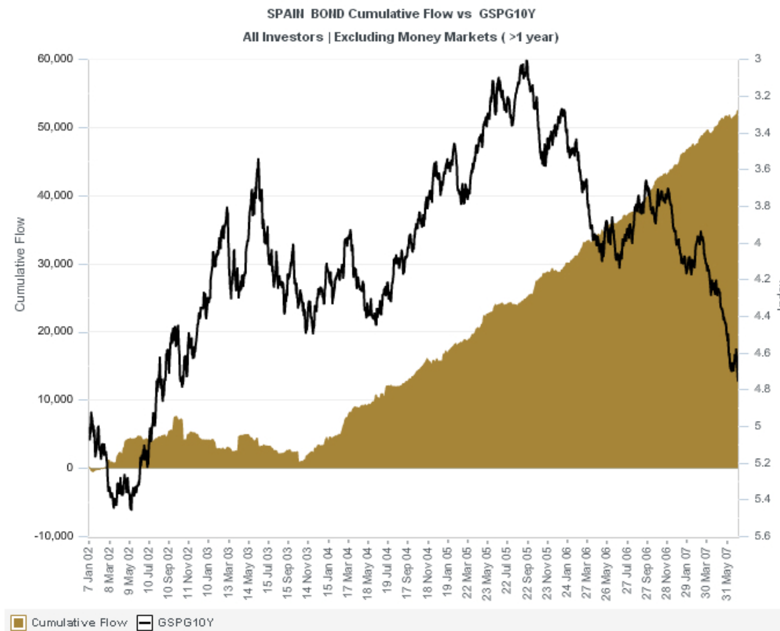
GSPT10YR


SPAIN BOND Cumulative Flow vs GSPG10Y
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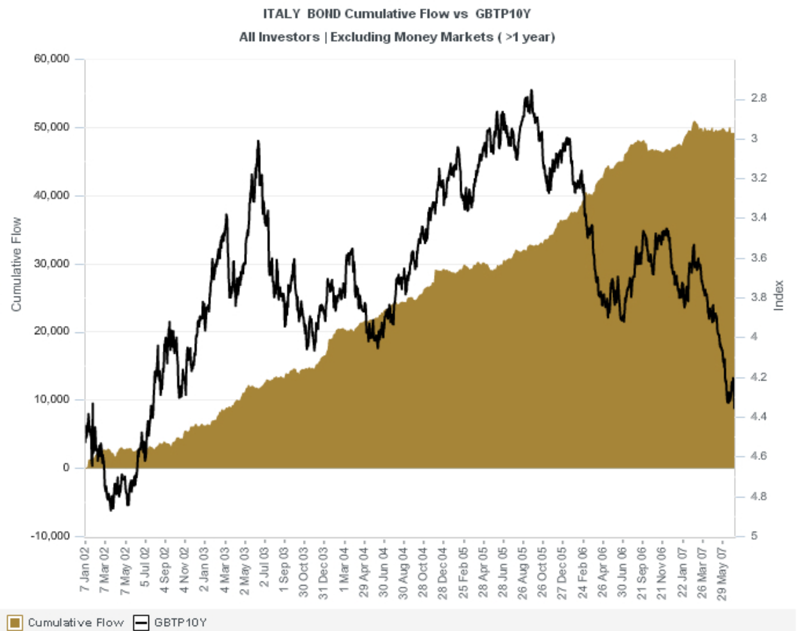
GSPG10Y


ITALY BOND Cumulative Flow vs GBTP10Y
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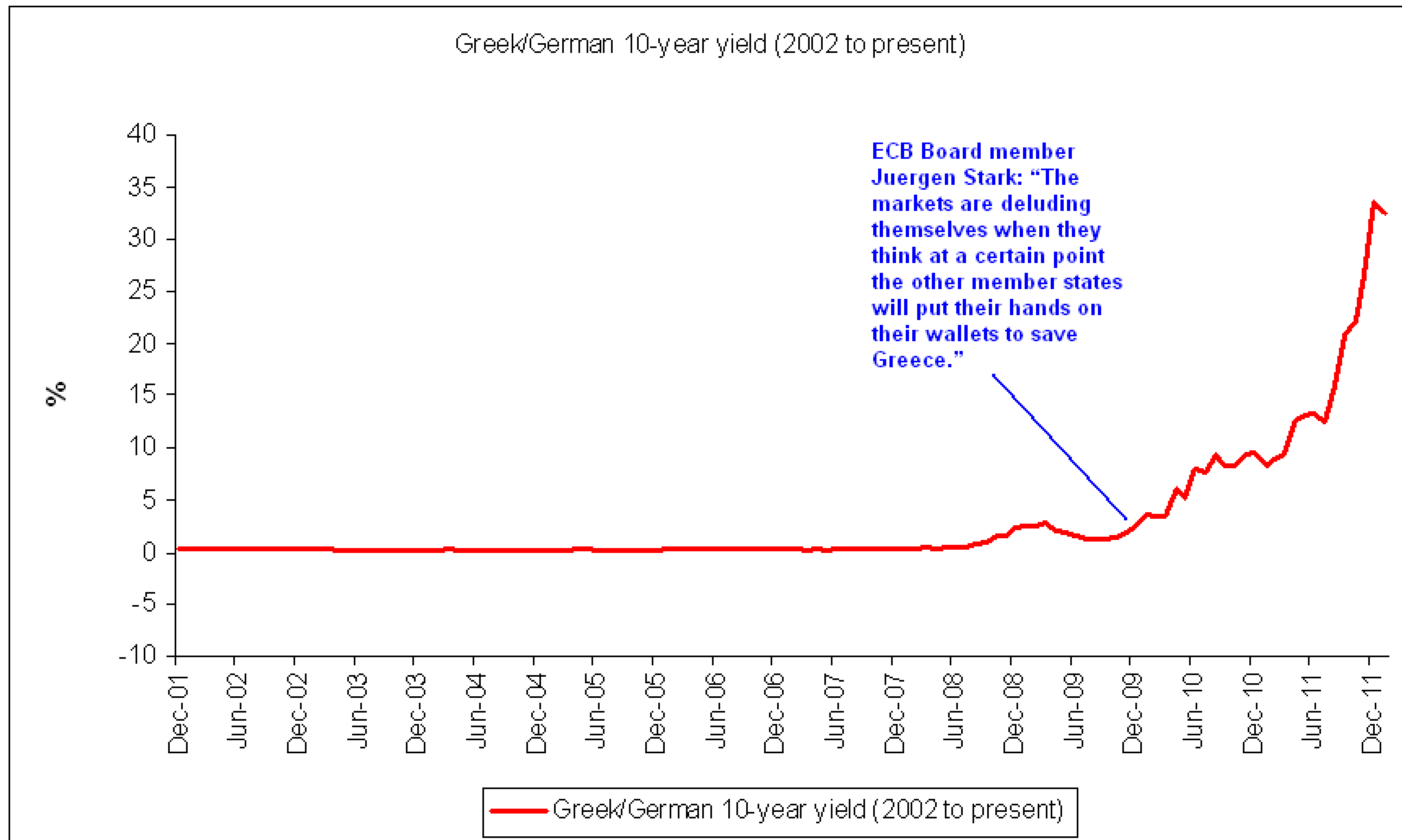
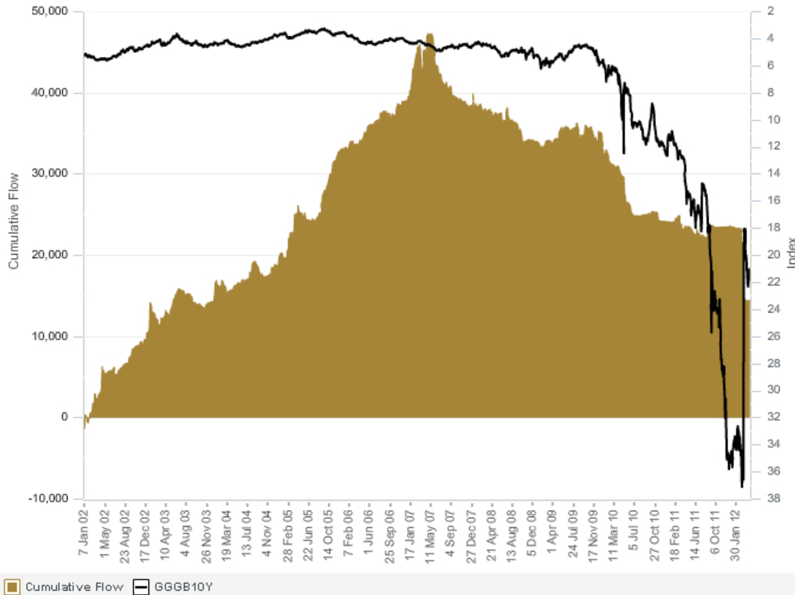
GBTP10Y

Investors treated Euro-zone as if it were a debt union

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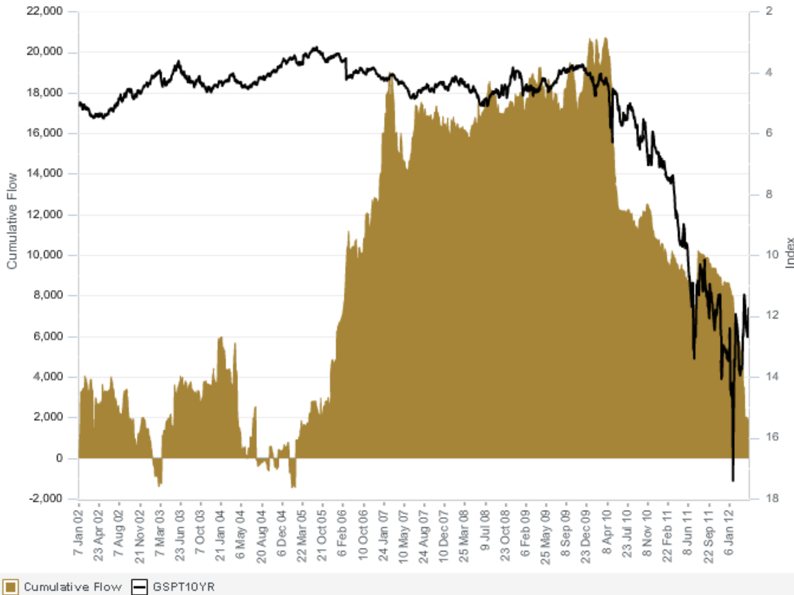
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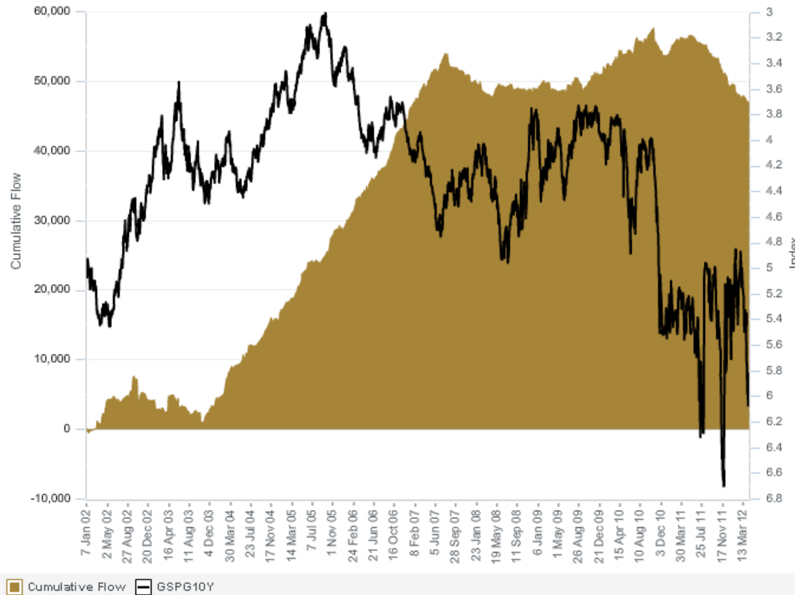
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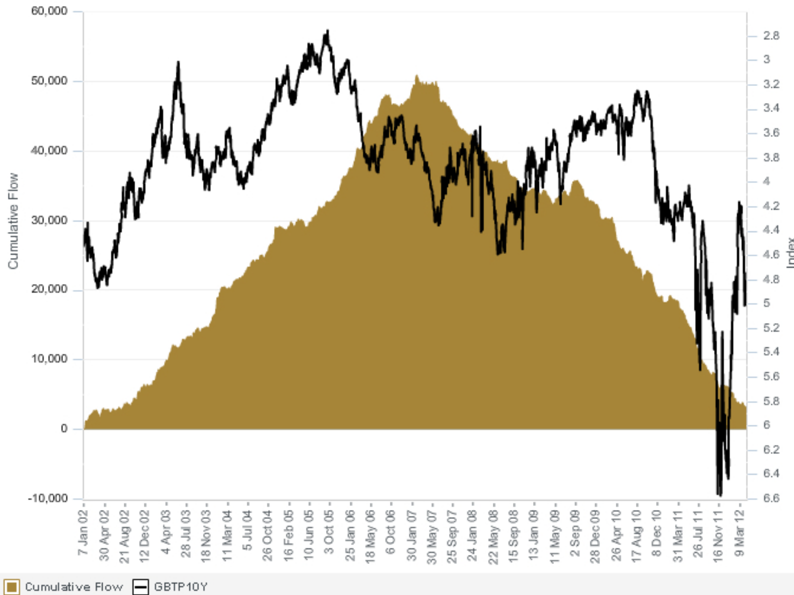
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The December summit

- The real choice facing the Euro zone at the December summit was whether or not is was going to remain a “stability union”.
  - If it was then its more peripheral members would need to decide whether they were going to transform themselves into a Germanic economy or make a dignified exit.
  - If, instead, it was to make the move towards true “fiscal” union then Germany (and the other Northern European states) would need to be prepared to pay more to borrow money themselves while the more peripheral members would have to be willing to sacrifice a significant degree of political independence.
- The December 9th decision made it clear that the Euro zone will remain a “stability union.”
- Response from ratings agencies was unenthusiastic
  - Standard & poor’s downgrades 9 nations (including France and Austria)
  - Moody's Investors Service noted that “the absence of measures to stabilise credit markets over the short term means that the euro area, and the wider EU, remain prone to further shocks and the cohesion of the euro area under continued threat.”
  - Fitch Ratings noted that “the gradualist approach imposes additional economic and financial costs compared with an immediate comprehensive solution.”
- The political response was rather more dramatic…..

Voters react negatively to handling of Euro-area crisis

- Defeats of incumbents
  - Ireland: Fianna Fáil (February 2011)
  - Portugal: Partido Socialista (June 2011)
  - Spain: Spanish Socialist Workers' Party (November 2011)
  - Creation of technocratic governments in Greece and Italy (November 2011)

Rising opposition to December 9th accord

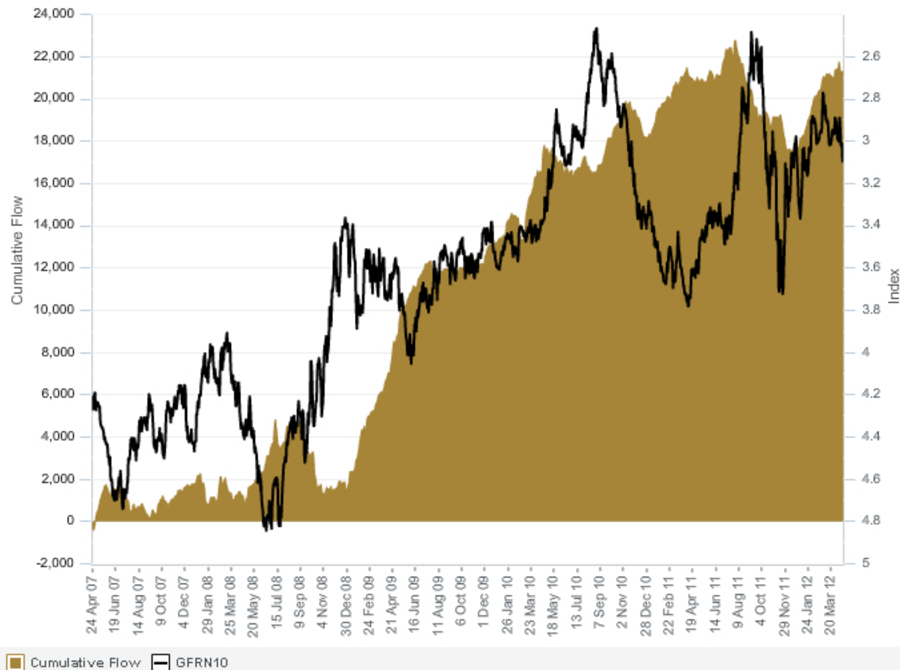
- **Spain:**
  - Youth unemployment stands north of 50% while housing market now down 7% y/y.
  - Government of Prime Minister Mariano Rajoy recently unilaterally declared that it would not target a budget deficit of 4.4% of GDP in 2012 but, instead, 5.8%. After negotiations between Olli Rehn, the EU commissioner for economic and monetary affairs, and Madrid, a compromise target of 5.3% was agreed upon.
  - The failure of Prime Minister Rajoy's People's party to win an absolute majority in the regional election in Andalucia in April made it clear that domestic political support for deeper spending cuts is simply not there at present.
- **Greece:**
  - 66% of Greek voters want to stay in EUR but are against agreed austerity measures
  - A Public Issue survey indicates that a total of eight parties are likely to cross the 3% threshold needed to enter parliament with six of these opposed to the bailout (ranging from the neo-fascist Chrysi Avyi to the communist KKE).
  - PASOK and New democracy struggle to put together working coalition.
- **France:**
  - Latest opinion polls show Mr Hollande going into May 6th presidential election with a 12-point advantage over President Sarkozy.
  - Mr. Hollande told RTL radio that "this accord is not the right answer ... If I am elected president, I will negotiate, renegotiate this accord." which is "all about austerity".
  - Has called on the European Central Bank to ease monetary policy and to defy the treaty by lending directly to states.
  - Some concern that Mr. Hollande may find himself forced to go beyond what he has already promised if the hard left ends up holding the balance of power after the June parliamentary elections.
- **Netherlands:**
  - Collapse of the governing coalition in late April was precipitated by Geert Wilders (leader of the Partij voor de Vrijheid) pulling out of budget cut talks, saying it was not in the national interest to meet the 3% deficit limit imposed by the pact.
  - The caretaker government will need to seek agreement on the budget with the opposition left wing parties.

Choices now facing Euro-area

- **Stick by December 9th accord:**
  - Rapidly declining support in peripheral nations
  - France and Holland were key allies for Germany in crafting the accord.
  - Sticking with accord risks pushing more voters to far-left and far-right Eurosceptic parties

- **Renegotiate the accord to pick up pace towards fiscal union:**
  - Although the “right” answer, voters may be in no mood for greater political unification within area

- **Let things slide**
  - Given political developments in “core” Euro-area, the most likely outcome.
  - However, risks an increasingly unhappy Germany electorate.


FRANCE BOND Cumulative Flow vs GFRN10
All Investors | Excluding Money Markets (>1 year)
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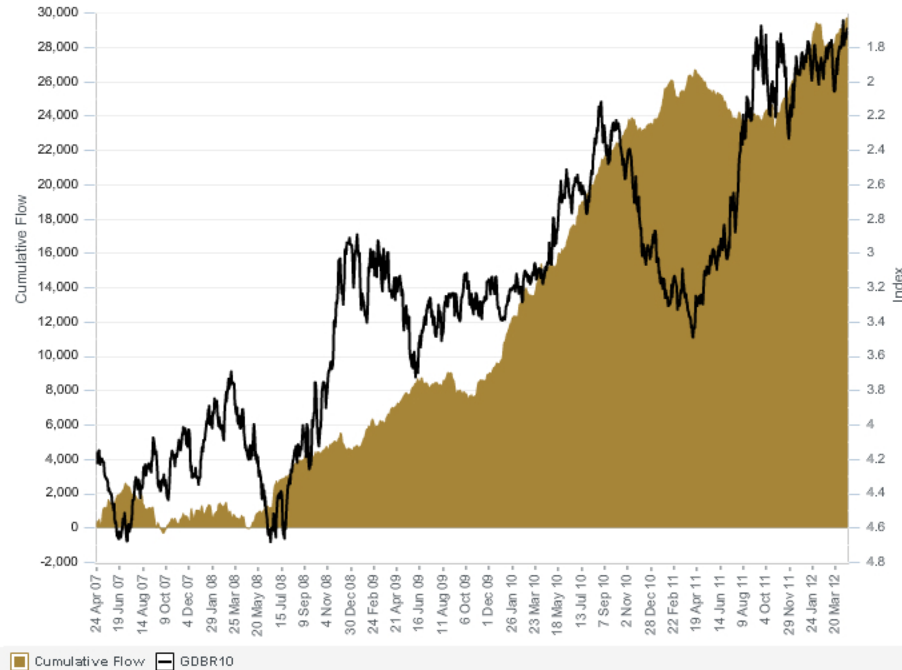
Cumulative Flow
GFRN10


GERMANY BOND Cumulative Flow vs GDBR10
All Investors | Excluding Money Markets (>1 year)
Cumulative Flow
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Cumulative Flow
GDBR10

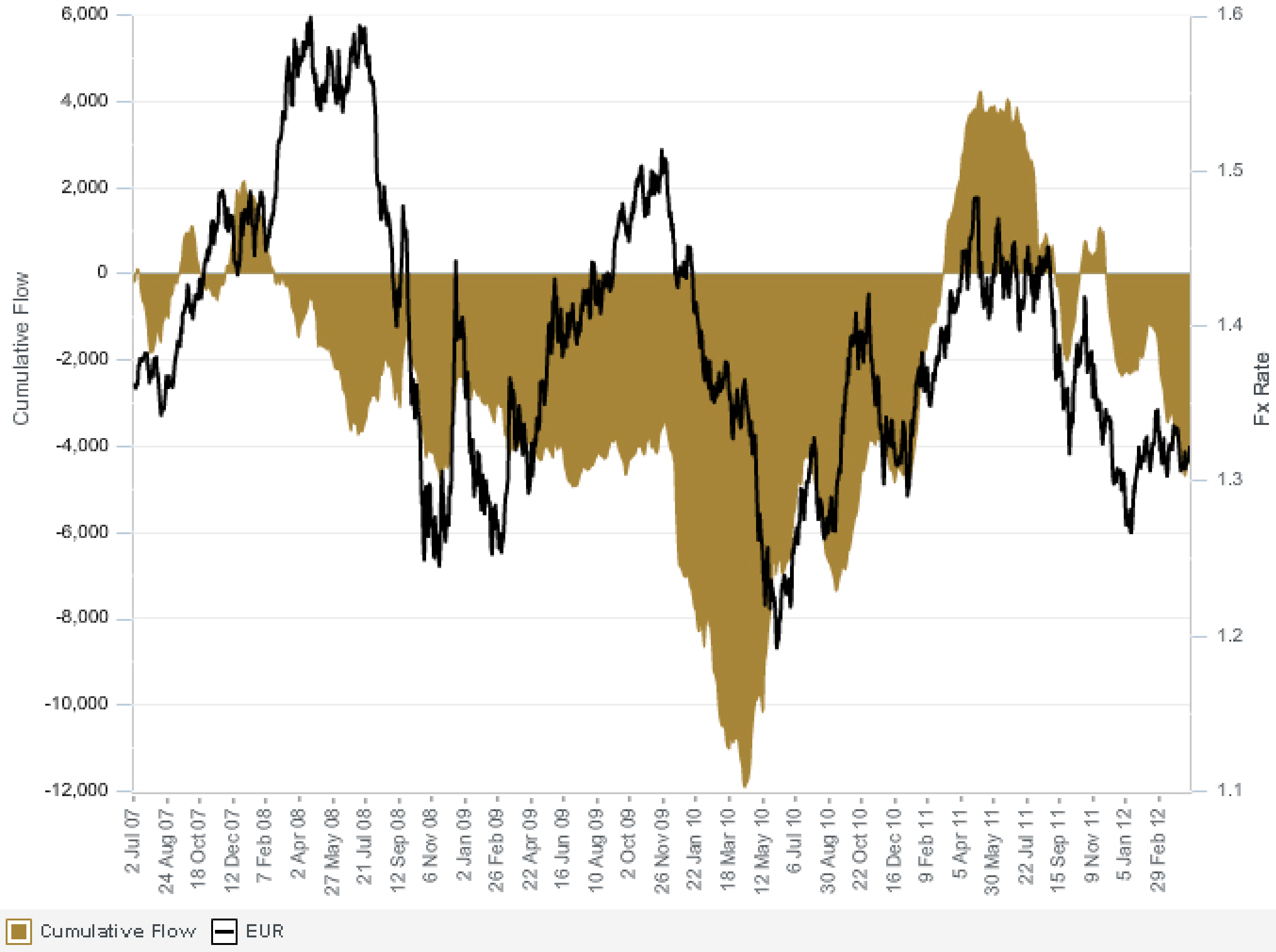
A “hidden” risk?

- FT’s chief foreign affairs columnist Gideon Rachman published an article in early April titled “The time bomb no one can defuse.”
  - Noted that “it is significant that, behind the scenes, a debate about the break-up of the EUR is also taking place among senior figures in the German establishment.”
  - “There was always a group of top German economists – call them the Bundesbank tendency – who had deep misgivings about the whole single currency project. Now some of these German sceptics believe their concerns are being vindicated and are even suggesting that – despite the current calm in the markets – Greece may have to leave the EUR within months.”
  - “One scenario doing the rounds in Frankfurt and Berlin is that the crisis could be provoked by the Greek elections, which are likely to be held in early May. A new Greek government might seek to unpick the latest debt deal, provoking a chain of events leading to Greece leaving the EUR.”
- Prime minister Lucas Papademos: “The consequences (of an exit) would be devastating. A return to the drachma would cause high inflation, unstable exchange rate, and a loss of real value of bank deposits. Real incomes would drop sharply, the banking system would be severely destabilized, there would be many bankruptcies, and unemployment would increase. A return to the drachma would increase social inequalities, favouring those who have money abroad.”
- German Chancellor Angela Merkel stressed that “it would be a huge political mistake to allow Greece to leave.”

BYE!

What would an “exit” entail?

- The announcement would have to come as a “surprise.”
- Markets would remain closed for a number of days in order that the bare minimum of financial plumbing could be carried out.
- A number of other announcements would have to take place at the same time.
  - Withdrawals from banks would have to be significantly limited to prevent a run.
  - Concurrently with this capital controls would be introduced (along with travel curbs). However, it also seems reasonable to suppose that any money looking to leave Greece has already done so.
  - Wages would have to be redenominated
  - Domestic debt contracts would have to be redenominated rapidly to prevent the bankruptcy of most households.
  - Temporary banknotes would need to be provided until permanent new notes could be introduced. A number of suggestions have been made including the “overstamping” of existing banknotes.
  - Price controls could be reintroduced on a temporary basis.
- Problems
  - Private borrowers with debts outside Greece would not be able to re-denominate them in the new national currency.
  - What would the monetary status of the debts of the national central bank be towards other national banks in the Euro System?
- Are there lessons to be drawn from the Asian crisis (many Asian companies had borrowed heavily in USDs rather than in their local currency)?


EUR FOREX Cumulative Flow vs EUR
All Investors
6,000
4,000
2,000
0
-2,000
-4,000
-6,000
-8,000
-10,000
-12,000
Cumulative Flow
1.6
1.5
1.4
1.3
1.2
1.1
Fx Rate
2 Jul 07
24 Aug 07
18 Oct 07
12 Dec 07
7 Feb 08
2 Apr 08
27 May 08
21 Jul 08
12 Sep 08
6 Nov 08
2 Jan 09
26 Feb 09
22 Apr 09
16 Jun 09
10 Aug 09
2 Oct 09
26 Nov 09
22 Jan 10
18 Mar 10
12 May 10
6 Jul 10
30 Aug 10
22 Oct 10
16 Dec 10
9 Feb 11
5 Apr 11
30 May 11
22 Jul 11
15 Sep 11
9 Nov 11
5 Jan 12
29 Feb 12
Cumulative Flow
EUR

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