Europe’s Debt Crises
A Muddled Policy Approach Is Yielding Tenuous Results

Contagion Fears

Investor concerns over a possible restructuring of Greek sovereign debt recently triggered considerable contagion across European markets. Not only did bond and CDS spreads rise markedly across the periphery, but global risk taking was also curtailed. The risks emanating from Greece are overshadowing the stability of the European financial system and the global growth outlook.

European policymakers have intensified their efforts in recent days to avert the crisis. They agreed to separate the thorny issue of private sector involvement (PSI), from the release of the next financing tranche for Greece. This approach appears to have ended a standoff between the European Central Bank (ECB) and Germany, which threatened to erode investor confidence. According to the Franco-German agreement reached on June 17, any PSI will be strictly voluntary and designed in a manner to ensure that ratings agencies will not consider Greece in technical default. However, in an apparent dilemma, the German government remains committed to its parliament to deliver ‘substantial’ contributions from PSI. Resolving this dilemma might be as difficult as fitting a square peg in a round hole.

Nevertheless, investor attention has begun to shift to more immediate issues. The Greek government led by Prime Minister (PM) Papandreou narrowly survived a confidence vote on June 21. Political pundits now expect that the PM will also mobilize political support for sweeping reforms in a critical vote on June 28.

Source: Bloomberg Finance LP
Parliamentary approval of budget measures and ambitious privatization plans is necessary to unlock the next tranche of the EU/IMF bailout. This is likely to occur in early July, in time for Greece to meet its large debt service obligations. Such a course of events would facilitate an easing of contagion risks and improve risk sentiment.

The EU/IMF adjustment programs in the periphery are focused on resolving the current liquidity crises. The high levels of sovereign indebtedness, however, suggest that Greece, Portugal—and possibly Ireland—may also be faced with a solvency crisis. Therefore, there is a prominent risk that some of these adjustment programs might soon veer off track. If the past is prologue, this could happen in Greece later this year or early next year—most likely paving the way for debt restructuring.

Key Issues in the Periphery

The following section provides a brief overview of the key issues confronting countries in the periphery, including Spain, Italy, Ireland, and Portugal.

Spain. Broad-based fiscal and financial sector reforms are gaining traction. The authorities aim to further curtail the general government budget deficit to six percent of GDP in 2011. However, this year’s adjustment efforts hinge primarily on the autonomous regions, while GDP growth may fall short of optimistic budget forecasts; fiscal shortfalls of about one percentage point of GDP seem likely in 2011. The market may test the minority government's resolve to take additional measures ahead of the March 2012 elections. Moreover, labor market reforms appear to have all but stalled, adding to concerns about the economy's long-term growth potential. On balance, we see the potential for Spain to emerge strengthened from the crisis, but the scope for positive outcomes is limited by policy uncertainties and considerable contagion risks.

Italy. The market remains convinced that Italy could withstand more broad-based contagion. This assessment seems to reflect in large part the fact that Italy's 2011 budget targets a moderate primary surplus; its structural deficit is less than half that of other countries in the periphery. Nevertheless, public sector debt is projected to reach 120 percent of GDP this year, the current account deficit has been widening, and deep-rooted competitiveness problems are weighing on growth and debt sustainability prospects. The authorities have steadfastly denied the need for policy action to limit contagion risks, although they could still take action in their 2012 budget which is currently being formulated.

Ireland. Solvency concerns remain at the forefront, despite decisive policy action. Ireland’s debt is projected to peak at 120 percent of GDP in 2013, as the primary balance is expected to return to a surplus the following year. However, this projection hinges on continued fiscal consolidation. The general government deficit is targeted to fall to 10.6 percent of GDP in 2011, 7.4 percent of GDP in 2013, and 3.0 percent of GDP in 2015. Fiscal adjustment is largely expenditure-based, which is a notable distinction from the emphasis on taxation in the (initial) Greek bailout program. Moreover, unlike Italy and Portugal—two countries which are experiencing elevated levels of public sector debt—Ireland is undergoing notable improvements in competitiveness. This has further bolstered exports during the first quarter of this year. The EU/IMF program is predicated on a return of the sovereign to the capital markets in late 2012, but

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1 Source: Italy Stability Program, Italian Government.
2 Source: International Monetary Fund, IMF.
this may prove to be an overly optimistic assumption.

**Portugal.** The market is also concerned about Portugal’s solvency. Moreover, the country’s economic fundamentals are substantially weaker than those of Ireland. Portugal exhibited the largest current account deficit, next to Greece, in the periphery in 2010 (10.4 percent of GDP). The combination of anemic economic growth and wide external deficits are symptomatic of Portugal’s entrenched competitiveness issues. Addressing these issues, in addition to comprehensive labor and product market reforms, would require substantially deeper wage cuts than the five percent cut in public sector pay that was implemented earlier this year. Furthermore, the program is predicated on a potentially over-inflated growth trajectory, raising the specter of fiscal shortfalls.

*The subsequent sections detail the outlook for Greece and the periphery’s largest economies, Italy and Spain.*

**Greece: Three Strikes and You’re Out!**

Despite defections from the governing party, the recently reshuffled cabinet of PM Papandreou narrowly survived a vote of confidence on June 21. Political pundits now expect that the PM will build on his victory and receive majority support from parliament for the government’s adjustment program in a critical vote on June 28. This program mainly comprises measures equivalent to 2.8 percent of GDP that are necessary to keep the budget on track to meeting this year’s deficit target (7.5 percent of GDP), and large-scale privatization efforts to raise an estimated €50 billion in financing by 2015. The EU and the IMF have made it clear that the release of the next financing tranche hinges on parliamentary approval of the requisite reforms.

There has also been progress with the resolution of the dispute among the European partners on the financing modalities of the Greek bailout. An agreement was reached between France and Germany that any PSI in the bailout should be strictly voluntary. Moreover, any PSI should avoid triggering ‘technical’ default, which would result from a possible downgrade of Greece’s sovereign rating (to selective default).
France and the ECB are concerned about the adverse effects of a technical default on European financial stability. Moreover, the ECB is also anxious about its balance sheet and capital. Analysts estimate that the central bank holds €444 billion in exposure to the periphery. Thus, any major price changes could erode ECB capital.\(^3\)

To complicate matters further, Germany’s parliament conditioned its support for another bailout to Greece on a ‘substantial’ contribution from PSI. Against this background, the discussions are focusing on a so-called ‘Vienna initiative.’ During the financial crisis, the IMF was worried that the sudden withdrawal of international lending could have caused capital account crises in several eastern European and Balkan countries. To prevent such an event, the IMF conditioned its own liquidity support on a commitment by the largest banks to maintain their exposure.

Broadly speaking, this approach was successful and avoided a deepening of the financial crisis, notably in Romania and Serbia. Banks that provided material funding to Southern and Eastern Europe typically had built costly local subsidiaries, and were faced with the threat of losing these investments as a result of a deepening financial crisis. The Vienna initiative acted as a “coordination device.” It facilitated a mutually beneficial outcome: foreign exposure was broadly maintained, a deepening of the crisis was averted, and foreign banks’ losses were limited.

However, this success will be difficult to replicate. Greece’s foreign lenders do not maintain costly subsidiaries in the country. This exposure does not seem to be in their best interest, short of any major policies to incentivize bondholders. The Vienna initiative may therefore result in lip service by foreign investors. Nevertheless, given the risks to macro stability from a possible disorderly default, the next EU/IMF tranche is likely to be disbursed in July, allowing Greece to remain current on its large debt service obligations.

In an indication that political stability remains tenuous, PM Papandreou called for a public referendum in September on the issue of constitutional reform. While this initiative may facilitate much needed reforms of the state and the economy, it risks being perceived by the public as a referendum on the PM and his government. A failure to mobilize majority support would most likely spur another political crisis and could lead to early elections.

Finally, the EU/IMF bailout is predicated on the notion that Greece is experiencing a liquidity crisis. The intensifying liquidity strain appears symptomatic of an underlying solvency crisis. If this assessment proves correct, one should expect the EU/IMF program to veer off track again, possibly in the not so distant future. Never say never…but a third bailout seems inconceivable, at least for now.

**Italy: The Ostrich Approach to Policy Making**

Italy’s economic development has markedly lagged that of the euro area and countries in Europe’s periphery since euro inception in 1999, as illustrated by the following charts. Real growth averaged 0.6 percent per year from 2000-2010, compared to 1.0 percent for Portugal and 1.4 percent for the euro area. During the same period, Italy’s goods and services exports rose an anemic 0.3 percent per year compared to 3.9 percent for the euro area. Net exports detracted from GDP growth in about half of the years since euro inception, indicating rising import penetration and sluggish export sector development. The impending export sector rebound lacks momentum relative to other European countries.

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\(^3\) See “A House Built on Sand? The ECB and the hidden cost of saving the euro,” by Raoul Ruparel and Mats Person, June 2011, Open Europe.
These developments point to far-reaching competitiveness issues. The authorities are concerned about a possible shift in global supply chains that could be detrimental to Italy’s traditional manufacturing industry. Following a decade of steady deterioration, the current account deficit reached 3.5 percent of GDP last year. The widening external imbalance is partially driven by the declining rate of household savings. The Bank of Italy’s latest annual report indicates that the decline in the savings rate is in large part driven by households at the lower end of the income spectrum. Given sluggish productivity and income growth, this suggests that the deterioration of the savings rate and external accounts is primarily structural. However, despite some policy efforts, comprehensive strategy to bolster productivity, competitiveness and sustainable growth is still lacking.
Against this background, the onus is squarely on fiscal policy. Unlike many other countries, Italy’s policy response to the 2008-2009 recession refrained from a deficit-increasing fiscal stimulus. Instead, expenditures were redirected to priority areas. Nevertheless, the public sector debt-to-GDP ratio edged up further to 119 percent of GDP last year. This increase was due in large part to a sharp contraction in output and a relatively high fiscal deficit, although the 4.6 percent of GDP outturn was below the 2010 target.

The 2011 budget targets a further reduction of the deficit to 3.9 percent of GDP. Given its commitments under the reformed Stability and Growth Pact, Italy is also aiming to reach near-budget balance (0.2 percent of GDP deficit) by 2014 to ensure a steady decline of its public debt ratio. The policy approach largely relies on expenditure reductions, as well as revenue gains from tackling tax evasion.

While we view this strategy as appropriate, it is afflicted with implementation risks, continues to lack specificity and, in some instances, credibility (as detailed below). We therefore expect fiscal slippages and consider the goal of nearing budget balance by 2014 as elusive, absent of further fiscal measures.

- **Implementation risks.** A sizable share of the spending reductions relies on a public sector pay freeze and reduced transfers to the region. However, the pay freeze is set to expire in 2013, and reductions in regional transfers may prove difficult amidst the impending fiscal federalism reforms.

- **Lacking specificity.** Even if these expenditure reductions were to be effective, 2.3 percentage points of GDP in fiscal measures remain to be identified to reach the near-balance target by 2014. The government has so far maintained that there is no need to specify these measures, regardless of contagion risks from the periphery. Preparations of the 2012 budget are underway and the government may reveal some of the measures needed to reach its 2014 target. Any continued lack of clarity, however, may foster further contagion.

- **Lacking credibility.** The fight against tax evasion is in direct conflict with Italy’s longstanding history of tax amnesties, since these tend to skew the incentives in favor of evasion. The latest amnesty was held only in 2009-2010, which invited the repatriation of undeclared funds held abroad.

Source: Statistical Annex, Spring 2011 Forecast
However, there are several positive factors that distinguish Italy from the countries in Europe's periphery.

- As shown above, Italy's dependence on foreign capital is significantly lower than for the peripheral economies. Prior to euro adoption, competitive devaluations helped limit current account deficits and external indebtedness. At the same time, the 2010 current account deficit was the largest in three decades, and external indebtedness may rise.
- Italy's structural fiscal deficit, estimated at 2.9 percent of GDP in 2010, is less than half that of Spain and other peripheral countries.
- The exposure of the Italian banking system to the periphery is fairly limited, suggesting that the banking system would be an unlikely conduit of contagion in case of a possible credit event in Greece.

**Spain: Policy Traction Faces Headwinds from Contagion and Growth Concerns**

Following a prolonged recession, a tepid export-led recovery has begun. Real GDP growth edged up to 0.8 percent year-over-year in the first quarter, as a rebound in exports offset a continued contraction in domestic demand. Employment losses, deleveraging, and fiscal tightening contributed to the contraction in domestic demand. Given that private and public sector adjustment will need to continue, prospects for sustaining the recovery over the near term hinge closely upon export market developments. Although growth is decelerating in Europe and elsewhere, global export demand nevertheless appears poised to sustain Spain’s recovery.

Longer term, the recovery hinges on the domestic economy, given that Spain’s export sector is relatively small (2010 export-to-GDP ratio 27 percent). In this context, further reforms are essential to enhance flexibility of the product and labor markets. However, discussions between labor and employer representatives stalled, and the government adopted further labor reforms in mid-June, which appear to only partially address current rigidities that are inherent to the collective bargaining and wage setting framework.

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*Source: International Monetary Fund, IMF.*

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*Source: IMF World Economic Outlook Database, January 2011*
As illustrated above, the recession saddled Spain with declining revenues, rising expenditures, and a large structural deficit. However, major policy efforts, both on the spending and revenue side, proved to be effective in 2010. Key measures included increases to the rate of value-added taxes and select excise taxes, as well as cuts in pensions and public sector wages. As a result of these measures, the general government deficit declined to 9.2 percent of GDP in 2010.

Expenditure cuts, combined with the permanent effect of the earlier tax measures, are key to continued fiscal tightening. The authorities target a reduction in the general government budget deficit of 6.0 percent in 2011. Overall, 5.2 percentage points of GDP in expenditure cuts—considerable by any standard—are projected to reduce the deficit to 2.1 percent of GDP by 2014. In a notable contrast to Italy, the Spanish authorities specified measures to achieve their 2014 budget target, including cuts to unemployment benefits, pension freezes, public sector pay freezes, and attrition in the public sector.

Nevertheless, the growth outlook and regional fiscal developments pose significant fiscal risks.

- **Growth.** The fiscal outlook is predicated on optimistic growth projections. The Bank of Spain and the IMF expect a sluggish recovery, with real growth rising 0.8 percent this year and 1.5 percent next year. However, the budget is predicated on real growth of 1.3 percent and 2.3 percent in 2011 and 2012, respectively.

- **Regional finances.** Fiscal discipline in some of Spain’s regions is weak. All regions combined were responsible for about one third of general government spending in 2010 and, therefore, are vital to the overall adjustment effort.

The risk of potential deficit overruns in the regional budgets is of particular importance this year. Almost half of the targeted adjustment effort (half of 3.2 percentage points of GDP) relies on fiscal tightening in the regions. Catalonia—the largest of 17 regions—announced that it would target a deficit of 2.7 percent of GDP (3.9 percent of GDP in 2010) instead of the centrally mandated 1.3 percent of GDP. Thus Catalonia alone could cause an overrun of the general government fiscal deficit by almost 0.3 percent of GDP this year.

Fortunately, all other fiscally-challenged regions are relatively small. In 2010, the overall regional deficit was 2.8 percent of GDP. Besides Catalonia, the deficit was higher than average in six other regions.
Assuming that all these regions would reduce their fiscal deficit this year by only 30 percent, which is in line with the reduction sought by Catalonia, this would add another 0.4 percent of GDP to the general government deficit. Altogether, the regions could therefore cause a fiscal deficit overrun of about 0.7 percent of GDP this year.

Adding in revenue shortfalls from possible growth disappointments suggest that measures of about one percent of GDP are needed to reach this year’s deficit target. Contagion may test the authorities’ resolve, and these measures may need to spelled out sooner than expected.

Banking sector restructuring is broadly proceeding in line with expectations. The strategy centers on: (i) setting conservative capital requirements; (ii) a September deadline for banks to raise the needed funds to meet the new capital requirements; and (iii) a commitment by the Fund for Orderly Banking Restructuring (“FROB”)—a government-funded entity—to fill any capital shortfalls until end-2014. Banks efforts to raise capital in the markets, however, may experience setbacks in the currently risk-averse environment. Bankia, the bank formed from the merger of seven large cajas (savings banks), is reportedly considering postponing its IPO to September.

While such a delay would appear to be temporary, it would nevertheless add to the perceived uncertainties. There is a wide range of market estimates for banking sector capital needs, with higher estimates in the order of 10 percent of GDP. Given a debt-to-GDP ratio of 60 percent of GDP (end-2010), even relatively high capitalization needs could apparently be funded by the public sector without raising immediate debt sustainability concerns. That said further significant declines of housing prices are likely and will weigh on banking sector capitalization. Nevertheless, we view potential fiscal shortfalls as a substantially more serious risk to macro stability than upside surprises related to banking sector recapitalization needs.

**Conclusion**

Europe’s policymakers have intensified efforts to resolve the Greek debt crisis and limit its contagion. The recent agreement to separate the discussions on PSI from the release of the next EU/IMF tranche is an important step to reduce uncertainties. The vote by the Greek parliament in support of PM Papandreou’s new cabinet suggests that parliament may also support the reform measures that are necessary to unlock further EU/IMF funding. Against this background, we expect the next financing tranche to be released in early July, although political uncertainties are extraordinarily high.
The adjustment programs in the periphery are focused on addressing liquidity needs. However, the crises in Greece, Portugal, and possibly Ireland, may be symptomatic of insolvency. Therefore, there is significant risk that these programs may veer off track, which would ultimately trigger a subsequent debt restructuring.

We expect the contagion resulting from such a scenario to test the resolve of policymakers around the globe. Policymakers in the periphery, including Italy and Spain, should be enhancing the credibility of their fiscal reforms and strengthening structural policies to bolster sustainable growth. Policymakers in Europe would need to consider an increase of the size of the EFSF, Europe’s bailout fund, despite increasing popular resistance to bailouts. Liquidity lines from most major central banks may be needed to limit liquidity risks to the financial sector. Moreover, the IMF may have to expeditiously provide liquidity lines to some of the countries that might experience contagion, and the recently approved ‘Flexible Credit Line’ should help facilitate this process.
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