Russell Investments

Market Update

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A note on the Eurozone: Expanding the three-legged stool to the concepts of liquidity and solvency

Throughout the Eurozone crisis, Russell strategists' view was predicated on the implicit assumption that a "messy"[1] outcome of the crisis would be so catastrophic and expensive that no rational actor would allow it to occur. We acknowledge that in recent weeks the probability of a messy outcome has increased markedly; international firms, large banks, outside observers, and indeed even key European policymakers have been heard of late openly musing about the breakup, reduction in size of, or re-formulation of the Eurozone. However, for the moment we will continue to base our analysis on the assumption that rational calculus prevails and decision-makers will ultimately choose the least costly of two outcomes, namely to do what is needed to keep the Zone intact.

A RE-STATEMENT OF THE THREE-LEGGED STOOL

After having eliminated the messy outcome scenario, we have long advocated an approach to the resolution of the Eurozone mess which has come to be known as the "three-legged stool" solution, more recently extended to the "three-legged stool with support ring". Broadly put:

1. Leg one involved increasing the size and remit of the EFSF and other international, multi-national, or joint-and-several financing mechanisms. Essentially providing sufficient funds to prevent weakness in one peripheral sovereign (like Greece) from spreading to other sovereigns (like Italy or Spain) that are too large to save. This could also extend to support on secondary bond markets and/or commercial bank support/recapitalisation.

[1] We define a "messy" outcome broadly as one or more of the following: an unscheduled (as opposed to coordinated and negotiated) default of Greece or other Eurozone sovereign; the withdrawal or ejection of a weak, non-core sovereign; the withdrawal of one or more core sovereigns; or the insolvency of a large, systemically important Eurozone bank that spreads fears of contagion throughout the European financial sector.

The costs to delay have become higher and the odds of a messy outcome have increased.

2. Leg two involved the recognition of and need to deal with debt relief in certain sovereigns. Some of these sovereigns on all but the most optimistic assumptions for future economic growth, fiscal consolidation and interest rate environments are de facto insolvent under present value calculations. Institutional provisions made at a collective level before these insolvencies become evident via market mechanisms are required. This is the idea behind previous and ongoing discussions of Private Sector Involvement (PSI) by large financial firms and voluntary acceptance of haircuts.
3. Leg three recognised a fundamental design flaw of the Eurozone; namely the bolting together of heterogeneous economies vastly different in economic and industrial structure and productivity, political traditions, implicit social contracts and growth models. At the fiscal level, it involves intra-governmental or supra-national agreements and enforced conditionality on fiscal matters and probably the surrender of some political sovereignty to ensure against ruinous excessive profligacy. However, properly constructed, this leg goes beyond mere austerity and the attainment of sustainable fiscal dynamics but involves fundamental economic and political reform, the re-writing of the social contract and reconsideration of intra-generational dependencies and economic and political institutional arrangements.

The support ring: Reliable, probably pre-announced and transparent support from the ECB to address the liquidity issues that otherwise solvent entities (states or banks) might need in the short- to medium-term while the three legs are being built and fused together into a coherent package. Indeed as discussed below, liquidity support is necessary to engender longer term solvency conditions, but liquidity support by either the ECB or via leg one has not been forthcoming as long as the solvency issues remain sticking points.

We, along with most others have watched with increasing disappointment while the political response has remained insufficient, uncoordinated, and up until now, ineffective. The cost to fixing the solution has increased as market dislocation has intensified and as more – systemically important – countries have been entwined in the crisis. Thanks to austerity, credit contraction, and an erosion of business and consumer confidence, the real economy of the entire Eurozone is now significantly weaker than it was at the beginning of the crisis. This weakness is spreading through a variety of channels to the rest of the world economy, threatening the already tenuous global recovery as we head into 2012. A global slowdown will only increase the odds of a messy outcome and increase the urgency to act in the very short term. Furthermore, fiscal arithmetic is becoming more and more acute. Amongst them, Italy, Spain and France need to refinance nearly €600 billion (Source: Bloomberg, November 2011) in 2012, and European banks approximately another €144 billion (Source: The FT / Decalogic, November 2011). Much of this approximately €750 billion is due early in 2012. The policy response to date has been insufficient, and has effectively run out of wiggle room. The costs to delay have become higher and the odds of a messy outcome have increased.

We still believe that the three-legged stool *with added* support ring is an accurate description for the policy prescriptions, but the late hour and rising risk has changed the nature of our recommendations and added an additional dimension, namely time horizon. Each element of the solution now has short and long-term requirements, which we broadly break into liquidity (or funding) and solvency.

LIQUIDITY AND SOLVENCY IN THE EUROCRISIS

The current crisis, and therefore suggested avenues to deal with it, may now be thought of as having a liquidity/funding element and a solvency/sustainability element.

Liquidity/funding refers to the need for sovereigns and banks to obtain financing to cover immediate cash flow needs (and in some cases to build up buffer cash for the 2012 wall of refinancing currently on the calendar).

For sovereigns, this essentially boils down to issuance. Since August, successive debt auctions have seen lower and lower coverage levels, and higher and higher interest rates being required by investors. This is most acute in Italy and Spain, but even for "core" countries recent auctions have been worryingly weakly subscribed. The European Central Bank (ECB) is expressly forbidden from engaging in primary market purchases and the EFSF and the other facilities set up during the past 20 months are only available for Greece, Portugal and Ireland; those countries officially involved in Troika bailout schemes.

Liquidity conditions in the European interbank markets have been steadily deteriorating since early 2010.

For banks, this boils down to their ability to obtain short term funding on wholesale markets. Relatively few European banks can rely on a sufficiently large depositor base for funding and have traditionally funded their operations on wholesale money markets. Much of this had been obtained through the issuance of short-term paper which US Money Market Mutual Funds (MMMFs) were happy to purchase. Beginning this past summer, MMMFs have been dramatically reducing their purchases of this paper as risks have increased, thereby intensifying the funding crisis. Liquidity conditions in the European interbank markets have been steadily deteriorating since early 2010. The ECB has been providing some liquidity support to banks during this phase.

This worsening liquidity squeeze can quickly become a solvency squeeze. Most

observers reckon that Italy and Spain are indeed solvent at the moment, but that if forced to fund themselves at ever higher interest rates, these countries could quickly run into solvency problems.

Solvency, in our paradigm refers to the long-term ability of borrowers, be they sovereign or other, to pay their obligations.

Discussions around "haircuts" for Greek debt imply the recognition that Greece is, in the long term, *de facto* insolvent. Solvency for a sovereign is a function of growth (hence tax revenues), spending, and the structural features of economies that affect those variables. Hence, as distinct from liquidity, solvency is a longer term issue that must be resolved through structural economic and fiscal reform, and perhaps *á la* the Greek case, debt forgiveness and restructuring.

For banks, solvency is a similar concept: the bank's ability to match balance sheet assets with liabilities through time. If the value of assets falls – either through declining value of sovereign paper held on its books, through corporate defaults as a result of weakening economic conditions or perceptions of banks' solvency deteriorates. The long-discussed need to recapitalise banks in Europe is recognition of looming potential solvency problems. Facing short-term funding problems exacerbates potential solvency concerns.

The feedback and interdependence of solvency and liquidity is clear, and is, in our opinion, the major impediment at the moment to resolving the crisis.

Measures to ensure liquidity (which as discussed below can be fit into our three-legged stool metaphor) are hard to craft because stakeholders who must participate in any solution are afraid to do so if solvency issues are not addressed first. The idea of "throwing money down a rat hole" is distasteful, and in most core countries politically difficult. Third party or non-European actors are making the same or similar calculations.

Conversely, measures to ensure solvency would be ultimately fruitless if liquidity concerns are not met. This dilemma is often likened to recommending lifestyle changes to a patient (solvency issues) who is near death (liquidity issues) at the

moment. All well and good, but moot if the patient does not recover in the short term.

THE THREE LEGS IN THE CONTEXT OF LIQUIDITY AND SOLVENCY

We now turn to the three legs (plus ECB support) of the stool and asses this liquidity/solvency dilemma in turn.

Leg one involves increasing the size and scope of any rescue facilities, recognising that the EFSF as currently constructed is insufficient to ensure solvency and liquidity for larger sovereigns like Italy or Spain as well as the recapitalisation needs of the banks.

To address liquidity, many proposals are on the table that would fit into leg one. Levering up the EFSF to nearly a trillion Euros by providing first loss protection on a portion of new treasury issuance, setting up an SPIV to attract foreign capital, engaging the IMF to widen and deepen its current rescue package, allowing the EFSF to lend to banks facing liquidity concerns are all liquidity measures. As described above, these measures have been incomplete and unsuccessful for the time being because larger, longer term solvency issues loom.

To address solvency, leg one may be seen to include any number of proposals towards fiscal union. “More” or “deeper Europe” Eurobonds or similar pooled fiscal instruments, the surrender of varying degrees of local sovereignty for access to such pooled resources, *et al*. We take no stand on which of these (or any other) schemes are most desirable, but simply note that they are longer-term solutions that will be necessary to ensure solvency, but only once liquidity has been addressed. We would add bank recapitalisation of varying means to the solvency question as it relates to financial institutions.

Leg two involves the recognition that in many cases, the current debt burden of some sovereigns is not sustainable, even if immediate liquidity needs are met. Leg two relates almost entirely to solvency, although the current lack of a final agreement on PSI (or in other words the appropriate size of – and adequate participation in – Greek “haircut” schemes) is due in large part to liquidity concerns. Various forms of bank recapitalisation could also fall under this leg if involved debt exchanges, covered bond exchanges or callable instruments being issued by national capitals. In some ways this is merely a restructuring of the aggregate balance sheet of the country in question, in which sovereign liabilities are created in exchange for destroying banking sector liabilities. This possibility is what lays behind rising bond spreads and threatened sovereign downgrades in core countries as the prospect of greater public liability is increasingly likely.

Leg three is the most difficult to define succinctly as it involves agreement amongst many actors as well as detailed design, both on the national and international level.

There is a national dimension to this leg, that deals with institutional arrangements at the EU-level as well as socio-political processes in the individual countries, involving the social contract between governments and the electorate, international competitiveness and changes to national growth models. These are the sorts of reforms that governments already involved in bailout programs need to continue to implement (and in some cases accelerate) and the sorts that new governments in Spain and Italy need to demonstrate unwavering commitment to.

At the international level, it will probably involve EU treaty revisions and on this measure will take up to several years for this leg to be fully built and operational. The long-dormant but now back in vogue Growth and Stability Pact is but one example of this. Broadly, this falls under the clarion of “more Europe”, the partial surrender of national sovereignty, and “economic governance.” Eurobonds or other joint and several funding mechanisms could conceivably fall under leg three, as they imply some degree of fiscal federalism. (But we leave this concept in leg one

as it surely involves a pooling of sovereign credit risk throughout the EU –and this is a leg one concept). The leg three concept involves conditionality and enforcement of the rules of the game to tap into these resources.

THE ECB IN THE CONTEXT OF LIQUIDITY AND SOLVENCY

There has been increasing call for the ECB to be more aggressive, more vocal about its intonations and transparently less limited in its SMP activities.

The ECB "support ring" around the inside of the three legs is necessary primarily for liquidity purposes. But even if deployed in full (which they have not been so far), ECB resources will probably have to stay committed for the long term to ensure that any liquidity support in the short term is not wasted due to insolvency in the longer term.

Putting aside for the moment objections from certain core countries and negative signals (so far) coming from Frankfurt itself, the ECB has intervened via the SMP, largely at the margin and in reaction to market dislocation. It is widely accepted that the ECB must be willing to intervene more aggressively and transparently on secondary markets to ensure smooth bond markets. Interest rate signals are powerful transmitters of market sentiment and also set benchmarks for primary funding prices and yields. Other suggestions for the ECB's further involvement include the ability to lend directly to the EFSF or indirectly through the European Investment Bank (EIB). In addition to limited support on secondary sovereign bond markets through the Securities Market Programme (SMP), the ECB has been active in providing liquidity support in broken interbank markets through its long term refinancing operations, the opening of US dollar swap lines with the Federal Reserve and liberal collateralized repo agreements as well as being a destination

for significant cash deposits from European banks.

As mentioned in passing immediately above, there has been increasing call for the ECB to be more aggressive, more vocal about its intonations and transparently less limited in its SMP activities. These calls have fallen on mostly deaf ears in Frankfurt and have met with significant resistance from German officials from Angela Merkel and Wolfgang Schaeuble on down. (See accompanying piece on ECB intervention from a few weeks ago.)

The arguments against more intervention are rooted in three main areas:

- Narrow interpretation of EU law (which prohibit the ECB from engaging in monetary government financing),
- Fears of monetarily generated inflation, and
- Moral hazard (if countries can depend on to inelastic ECB bond purchases, they will be less inclined to pursue leg-three type provisions).

We reject all of these. Briefly, the first argument can be countered that the ECB is allowed to undertake secondary market operations to ensure the ease of transmission of monetary policy in keeping with its price stability mandate (indeed this was the expressed intent of the SMP when it was launched in March 2010). On the second count, we note that SMP purchases are fully sterilised, and we point to the recent sharp deceleration of broad money aggregates as the credit crunch sets in. Finally, it is well understood that ECB purchases alone will not ensure solvency (nor even, by themselves liquidity) and that external lending with strict conditionality will be the preferred and more important "carrot" to keep austerity on track.

We suspect that the ECB will be induced to venture outside its current comfort zone of limited, marginal SMP purchases once all or most of the following four conditions have been met:

- Funding conditions have deteriorated so much that the ECB will be forced to go in and "go in big."

- Clear, credible, and concrete action by new governments in Spain, Italy and Greece on austerity
- Some degree of concreteness and consensus on the design of the other three legs our stool, both in its approach to liquidity as well as solvency
- Acquiescence from Germany on the need for core countries to pledge more of the resources and political capital to meaningful short and long term solutions.

Two more comments on the ECB's role are warranted at this point.

Any attempt to explain what a post-breakup Euro would look like will almost surely be inaccurate.

Although primarily a shorter-term solvency function, extension of ECB support to sovereigns and possibly banks, once undertaken will not be unwound soon. In many ways, this is similar to the Federal Reserve's Term Auction Facility (TAF), Term Asset-Backed Securities Loan Facility (TALF) and GSE purchases during the 2008 subprime crisis. Once liquidity has been provided through market operations, those assets bought by the central bank will probably need to be held by the ECB for a prolonged period of time, perhaps even to term.

It cannot be ruled out that as the Eurocrisis continues to place a strong brake on credit creation and economic activity generally, a broad interpretation of its price stability remit could see it engage in outright quantitative easing (i.e. unsterilized purchases of government and other securities) to offset deflationary forces should they arise.

GENERAL MUSINGS ON A MESSY OUCTOME

At this point we reiterate that we put a low-but-not-quite trivial probability on a messy outcome of the Eurozone crisis, and therefore retain faith that although more ambition is required now and any solution will be much more costly than had it been properly crafted many months ago, some form of the three-legged stool, including both liquidity reinforcing and solvency enhancing provisions will ultimately prevail. However, we also reiterate that time is getting shorter and solutions growing costlier. The Eurozone could soon find itself one failed bond auction, one bank insolvency, one politically rancorous summit away from a violent and fast negative feedback loop.

We could write much more on the worst-case scenario. For the moment, we simply note that any attempt to explain what a post-breakup Euro (or even an uncoordinated Greek default) would look like will almost surely be inaccurate. There is no intuitional framework currently in existence to set a backdrop to the market and economic fallout; policy responses will be *ad hoc* and probably undertaken in an unwieldy combination of national and supranational fire fighting, much of it conducted in panic mode with short time horizons, and in a noisy uncertain climate. We have previously discussed the transmission mechanism of this shock to global markets and economies as consisting of five broad channels (contagion, collapsing confidence, a severe credit crunch, general and broad market illiquidity, and real economic effects). Hard to measure, to be sure, but undeniably deeply interconnected and quickly transmitted.

CURRENT STATE OF PLAY

At the time of writing, we note that there is little time left for adequate structures to be built and that any solution must address both liquidity and solvency more or less simultaneously. We view the deterioration in sovereign markets even amongst core countries, as well as the general negative market mood as, perversely, a good thing. Since August we have been of the belief that "it has to get worse before it gets better." Reluctant actors apparently require a march up to and look down into the abyss before they are moved to do the right thing. The Eurozone summit on 9th December is undoubtedly an event of Rubicon-like significance. The Eurozone can probably muddle through for a few more weeks thereafter (or at most, months)

as long as the summit presents a clear and credible plan to build these structures, with less ambiguity and more attention to the detail of mechanism design than previous summit agreements (especially that of 26th October). A broad and unified front must be presented. After that, there is little time to actually start building and implementing whatever solutions emerge; the refinancing schedule picks up again in earnest in January. As with previous summits, particularly the 21st July and 26th October meetings, we expect the week leading up to the summit to feature a lot of "noise" as politicians and other leaders present trial balloons, publically stake out positions ahead of time and last-minute pre-meetings raise expectations and potentially result in temporary disappointment.

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