CAPITAL MARKETS RESEARCH

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Special Update

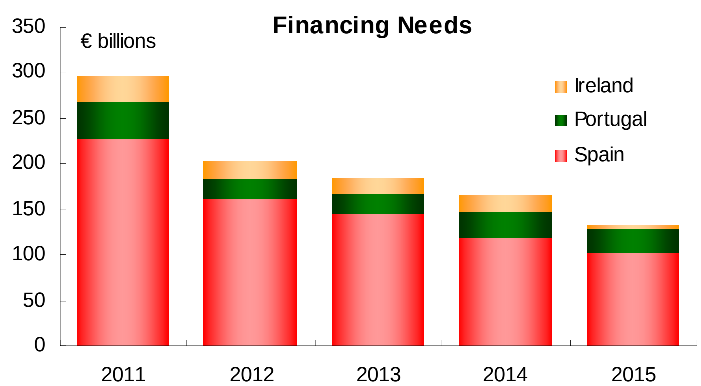
Can the EU Absorb Problems In Peripheral Economies?

Challenges facing peripheral European economies have the capacity to stretch the existing relief apparatus that was established in May to its limits with little margin for error.

Under what we feel are reasonable assumptions, however, we cautiously offer the view that this apparatus has the technical capability of smoothing over the coming adjustment period particularly in terms of the massive amount of financing that needs to be rolled over in 2011. Several critically important caveats bear continual monitoring and could derail this view, but one shouldn't dwell only on the negative risks. Given the pressures and uncertainties, our conclusion is that we anticipate further rolling bouts of risk aversion toward European sovereign and private debt markets into 2011, but remain faithful to our view that the over decade-long Euro experiment will remain intact and that the required policies may well be put in place in order to strengthen the euro zone in future.

Estimated Funding Needs

The accompanying table on page 5 is our attempt at evaluating a funding scenario for Ireland, Portugal and Spain over 2011-15. Chart 1 depicts the bottom line results by way of the financing amounts required for each country. We use Bloomberg figures for maturing debt and interest payments per year by country including bonds and bills and loans, and also including agencies. We also use net borrowing requirements recently forecast by the IMF.



Note: Includes bonds, bills and loans including agencies
Source: Bloomberg, IMF, Scotia Capital Economics.

The result is that the financing pressures facing the peripheral euro zone economies have yet to reach their peak. That point arrives next year when Spain and Portugal have large amounts of funding to roll over, and this is combined with hefty incremental net borrowing requirements. Spain's greater needs are roughly proportionate to its economy being about six times larger than either Portugal's or Ireland's. We combine the results instead of just considering net borrowing requirements because markets may well be less and less hospitable toward rolling over previously existing debt without exacting stiffer spreads. Each of these countries is pressured not just because of their domestic economies and years of fiscal deficits, but also because their debt management strategies relied excessively upon shorter-term obligations unlike, say, the UK which has extended obligations further up the curve.

All totaled, Spain, Portugal and Ireland combined face nearly €300 billion in net funding requirements, maturing debt obligations, and interest expense in 2011. Ireland's funding requirements excluding bank capital requirements are reined in by the additional €15 billion in austerity measures being pursued by the proposed four-year budget. These amounts taper off materially over future years, but remain high throughout the adjustment period. In fact, as short-term debt keeps getting rolled over, individual future years will themselves face even higher financing requirements than what is shown in the forecast horizon. But as this occurs, any amounts requiring backing through the stabilization apparatus would largely drop out from year to year for maturities under one year.

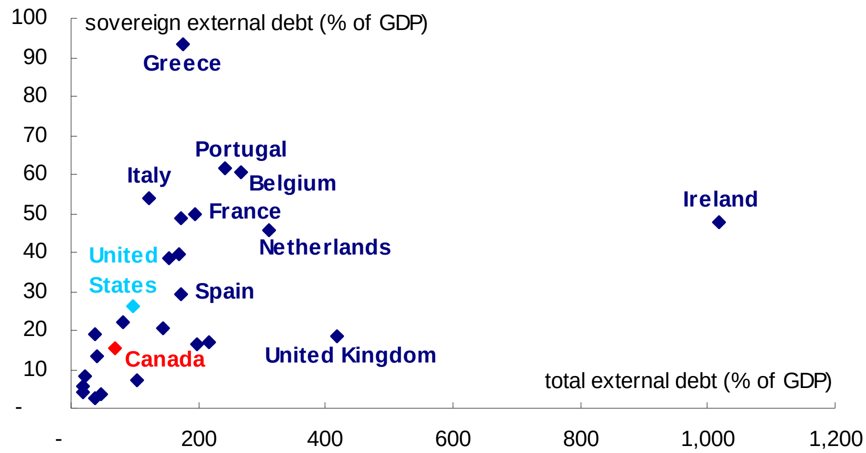
Over the period of 2011-2013, these three economies will require about €680 billion to cover maturing debt, interest payments and net lending requirements. Excluding additional assistance for banks, this is split between just over €60

While the views expressed are our own, we would like to gratefully acknowledge advice and input provided by others including Tuuli McCully, Danny Mitchell, Roger Quick, Oscar Sánchez, Camilla Sutton, Sacha Tihanyi, Mary Webb, and other anonymous referees.

billion for Ireland, €85 billion for Portugal, and €530 billion for Spain. This falls within the €750 billion assistance package that is comprised of the €440 billion in country loan guarantees within the European Financial Stability Facility (EFSF) that issues bonds to make loans to recipient countries, the €60 billion European Financial Stabilization Mechanism (EFSM), and the €250 billion IMF regional fund, but only barely so. We will revisit how realistic this is in a moment, but for now, clearly this puts in context the pressure to address the challenges facing European debt markets before they hit Spain harder.

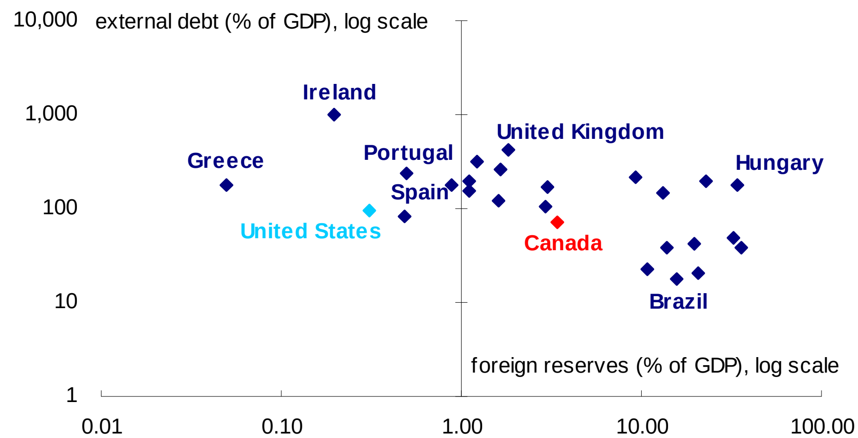
Adding in additional requirements for banks is extraordinarily difficult. Irish banks appear to be on the verge of receiving approximately €35 billion as part of the coordinated aid package. Adding this into the total financing requirements for all three countries raises the requirements to the €715 billion mark. At this juncture, we assume little by way of additional capital requirements for Spanish and Portuguese banks partly based upon the summertime European stress-testing exercises. One cannot, however, rely exclusively upon the outcome that depicted Portugal in a net capital surplus position and Spanish banks (mostly savings banks) falling short by €14-16 billion most of which has since been met. That's because Ireland also skated through the stress-testing exercises in fair shape, but the crisis of confidence in Irish banks and the resulting deposit flight required further injections. Should such risks materialize in Spain and Portugal — and there is thus far little hard evidence to support this view — then the upper bound on our estimate of financing requirements would likely meet or breach the aggregate size of the existing apparatus.

Ireland And Greece Are The Most Indebted To Foreigners...



Source: World Bank, Scotia Capital Economics.

...And Have The Lowest FX Reserve Buffers



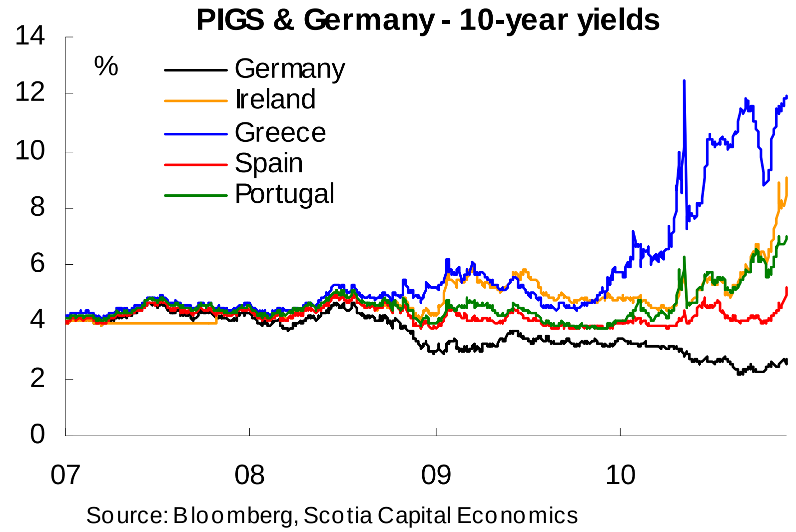
Source: World Bank, Scotia Capital Economics.

Positive Risks….

Now for the balanced caveats to the analysis. The two tail risks are enormous, and we start with why we may be over-estimating the scope of the problem facing Europe. First, in comparing what the peripheral economies must raise to the size of the existing assistance apparatus, we are implicitly assuming that each country is entirely shut out of markets, is unable to impose additional austerity measures designed to mitigate funding requirements, the ECB fails to provide further assistance, and each country is unwilling to impose hair cuts or restructurings on banks and other bond holders. We deem each of these assumptions to be unrealistic as further austerity measures are arriving as evidenced by Ireland's updated four-year plan and Portugal's approval of its 2011 budget, the cost of accessing capital may rise much further but is unlikely to shut out borrowers at any short-term price, the ECB is likely waiting in the wings to provide support to Ireland pending approval of its updated four-year fiscal plan, and bond holders will be leaned upon to share more of the burden of adjustment. In this case, our funding requirement totals are too high and that only strengthens the argument that Europe retains the technical capacity to absorb challenges to its peripheral economies. The point about the ECB may well include a greater role for the Securities Market Program introduced in May of this year.

Second, the size of the EFSF and the EFSM may be expanded along the lines of guidance provided by ECB Council Member and Bundesbank President Axel Weber's comments. News reports are flagging the European Commission's desire to double the size of the programs, but Germany's support for such an action lies in doubt. In our view, a large increase in the apparatus would be required should Spain require assistance since the market's bias will move onto the next countries.

Third, should the domino effect become further aggravated, the risks to global financial markets and economies may well merit coordinated central bank and supranational agency action against the sources of speculation. Tapping existing or throwing out more swap lines and/or coordinated currency intervention could become among the options.



Fourth, on balance, we remain of the bias that the domestic financing capabilities of the Spanish and Portuguese economies are considerably stronger than Ireland or Greece as measured by external debt-to-GDP ratios either in total or just the sovereign's share, and in terms of their FX reserve buffers.

An important caveat is clearly that Ireland is fully funded until the middle of next year whereas Spain and Portugal face the more immediate funding pressures, and Ireland's receipt of aid (pending politics) largely addresses its challenges. Further, Ireland's external debt is significantly impacted by the external debt positions of foreign banks operating in Ireland, but even without it the country would rank among the highest in Europe by this measure. Much of Ireland's external debt—and that of others—is also offset by foreign financial assets held by domestic residents. It must also be noted that Ireland has a relatively fair-sized sovereign wealth fund. But on balance, the odds that Spain and Portugal can address their own difficulties without resorting to assistance are greater than for Ireland and Greece where the former's problem was private external debt of its banks and the latter's issue is the single name risk of the sovereign. To this effect, we reproduce our two charts showing the external debt and FX reserve positions of global economies (charts 2, 3).

Nevertheless, such advantages require rational markets whereas the confidence factor is causing yields for all parties to rise materially of late (chart 4). As an additional aside, the importance of FX reserves for nations within a common currency union is exaggerated, particularly for those countries that may have higher shares of their external debt denominated in domestic versus foreign currency units for the sovereign and/or the corporate sector.

….and Negative Caveats

But there are very important negative caveats that bear continual monitoring. One is that although the summertime European stress tests posed little difficulty for banks in Ireland, Portugal and Spain, developments since then have emphasized that we're dealing with a market confidence issue. Stress tests assume rationally functioning markets and don't apply in periods of deposit flight such as what Irish banks have experienced. Should this lack of confidence grow, then the funding requirements could widen further and pose material challenges to the existing apparatus beyond the additional capital requirements now facing Irish banks. That may also occur given deepening concerns over the impact of accounting rule changes in Spain that require lenders to divest depreciating assets and that may accelerate the speed by which foreclosed homes reappear on the market. That would put additional downward pressure upon home prices and further aggravate the risks facing the economy and bank capital positions.

Second, a high AAA rating is required for the EFSF in order to connote a funding advantage to lower-rated countries. The way ratings agencies have judged the facility requires this AAA to be supported by AAA rated guarantors, and by cash reserves and buffers. This is thought to reduce the effective size of the funds available through the 440 billion EFSF by up to about 40%. That said, European governments have emphasized that they will do what it takes to maintain this AAA rating and perhaps raise its effective size to recapture some of the "lost" 40% through options such as offering liquidity lines. At a minimum, the last thing Europe would want is for this facility to face the risk of its own rating downgrades, though it is not inconceivable that some scenarios could challenge the credit rating of some of the guarantors themselves.

Third, politics within recipient and donor countries are clearly an additional wild card. Thus far we remain cautiously optimistic that Ireland and Greece will successfully manage political risk, and that Germany will remain resolute in its shared backstopping approach.

Fourth, accessing the EFSF entails high costs to the recipient country that asks for aid. Thus, it is viewed as a last resort option as evidenced by Portugal's hesitations. A nation's credit markets can become materially beleaguered before this point arrives, as we've observed in Greece and Ireland.

Another caveat is that we've stopped our analysis at these three economies. Frankly, should bail outs broaden to also include Portugal and Spain then the risk is that they take in even more economies with Italy the next most likely. The resulting funding requirements are then likely to overwhelm the existing stability apparatus thus requiring further policy action beyond the existing apparatus. To repeat, this emphasizes the importance of drawing a line at Spain.

Sixth, the greater the number of individual countries requiring assistance, the fewer the number of countries contributing to the assistance apparatus itself since by definition they drop out of the donor country pool. This must either be offset by increased amounts from remaining participants or the risk is that the overall apparatus is inadequate.

Seventh, fiscal projections for funding requirements may face revisions in light of downside risks to the domestic economies of the affected countries. In this regard, however, it is worth noting that Spain is more aligned to German economic strengths than Ireland or Greece.

Eighth, in order to rein in the funding assumptions, additional fiscal austerity is needed as evidenced by this week's Irish budget for the next four years. What concerns us in this regard is that successive rounds of fiscal austerity become progressively less effective. That's in part because budgetary savings become more difficult to achieve as fiscal austerity pressures economic growth, thus depressing revenues and raising some expenditures compared to possibly optimistic growth assumptions. It's also because successive rounds of cutting become progressively more difficult to do as budgets get progressively leaner.

Finally (or perhaps not), we're uncertain of the potential for issuance within the EFSF to crowd out other highly rated issues and thus potentially impact yields on AAA bonds.

Uncertainties Facing the Euro

There are clearly enormous uncertainties involved in evaluating the course of events in European bond markets. But thus far—and against the views of EMU critics—we remain of the view that it is far too premature to assume the Euro itself lies in peril versus the more likely scenario of a weaker Euro after a summertime rally against the USD that had more to do with concerns about the US economy and QE2 than any subsiding of European debt worries.

For one thing, the costs of abandoning the Euro would be even greater than preserving it. One reason is that abandoning the euro would be even more negative for the spreads demanded of weaker economies, as well as for the safety and soundness of their banking and capital markets. In this regard, Spain's Finance Minister Elena Salgado is correct in arguing that the impact of the crisis would be far greater if not for the Euro as any benefits of currency flexibility would be negated by even wider spreads as in the pre-Euro past. The absence of the stabilizing influences of the Euro would, in turn, be destabilizing for much of Europe and not in Germany's best interests either. The degree to which bank debt and other obligations and assets are shared across countries sharing the same currency would also face massive risks and revaluations should dead currencies be brought back to life.

It's also not clear whether the Euro would appreciate or depreciate through any dissolution since that depends on whether the strong or the weak leave, and there is no clear mechanism for dissolution in any event. Should Germany leave, then holders of German obligations may benefit from swapping out of Euros into resurrected deutschemarks but this depends on the rate of conversion which itself was a hotly contested issue in the creation of the Euro in the first place. Holders of the remaining Euro obligations would, however, likely suffer further depreciation. Should the weaker players leave, however, then perhaps the Euro strengthens but the holders of obligations belonging to the departing countries that are denominated in Euros would quite likely suffer material mark-downs.

Indeed, if greater fiscal policy oversight, strengthened transfer systems, and perhaps more integrated capital markets that could one day include Robert Mundell's advice to create a US-style Treasury market eventually arrive as appears to be the case thus far, then out of crisis may emerge a stronger European monetary union and with it a stronger long-run Euro. To this effect, however, we also observe that the pressure within Europe to converge toward common tax policies is exaggerated in terms of the economic merits, with Canada offering a case of how vastly different tax regimes can exist across regional jurisdictions within a monetary union.

Financing Requirements Facing Spain, Portugal and Ireland

billions of euros except where otherwise noted

Spain	**2011**	**2012**	**2013**	**2014**	**2015**
Net lending/borrowing	(73.9)	(69.4)	(63.6)	(57.7)	(54.0)
Maturing debt rolled over	132.6	73.8	66.2	46.9	37.9
Interest payments	20.6	18.0	15.7	13.2	11.4
Total	**227.1**	**161.2**	**145.5**	**117.8**	**103.3**
GDP	1,064.1	1,095.6	1,134.3	1,177.5	1,223.4
total as % of GDP	**21.3**	**14.7**	**12.8**	**10.0**	**8.4**
Net lending/borrowing as % of GDP	**6.9**	**6.3**	**5.6**	**4.9**	**4.4**

Portugal	**2011**	**2012**	**2013**	**2014**	**2015**
Net lending/borrowing	-9.0	-8.4	-7.7	-10.6	-11.1
Maturing debt rolled over	27.02	9.46	9.77	15.37	11.93
Interest payments	5.07	4.66	4.24	3.72	3.13
Total	**41.1**	**22.5**	**21.7**	**29.7**	**26.2**
Nominal GDP	172.9	175.8	180.1	185.2	190.9
total as % of GDP	**23.8**	**12.8**	**12.0**	**16.0**	**13.7**
Net lending/borrowing as % of GDP	**5.2**	**4.8**	**4.3**	**5.7**	**5.8**

Ireland	**2011**	**2012**	**2013**	**2014**	**2015**
Net lending/borrowing	(13.1)	(8.9)	(6.4)	(3.6)	(1.3)
Maturing debt rolled over	10.6	5.9	6.0	11.9	0.2
Interest payments	4.2	4.0	3.8	3.5	3.0
Total	**28.0**	**18.8**	**16.3**	**18.9**	**4.5**
Nominal GDP	161.6	168.3	175.9	185.0	195.0
total as % of GDP	**17.3**	**11.2**	**9.2**	**10.2**	**2.3**
Net lending/borrowing as % of GDP	**8.1**	**5.3**	**3.7**	**1.9**	**0.7**

Cumulative requirements:	**2011**	**2012**	**2013**	**2014**	**2015**
Net lending/borrowing	(96.0)	(86.7)	(77.7)	(71.9)	(66.4)
Maturing debt rolled over	170.2	89.1	82.0	74.1	50.1
Interest payments	29.9	26.7	23.8	20.5	17.5
Total	**296.2**	**202.5**	**183.5**	**166.5**	**134.0**
Nominal GDP	1,398.7	1,439.7	1,490.4	1,547.7	1,609.2
total as % of GDP	**21.2**	**14.1**	**12.3**	**10.8**	**8.3**
Net lending/borrowing as % of GDP	**6.9**	**6.0**	**5.2**	**4.6**	**4.1**

Sources: Bloomberg, IMF, Scotia Capital Economics

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