Mattioli Woods
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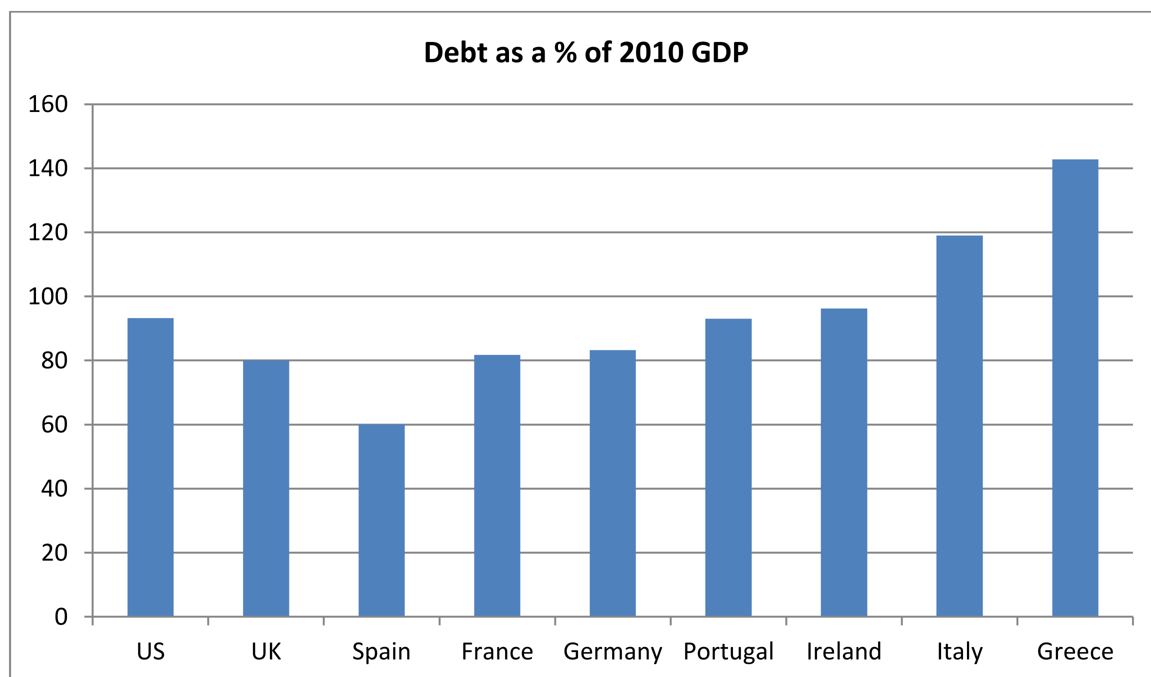
MANAGING WEALTH *EXPRESS*

The eurozone – how bad is it?

There has been a raft of measures implemented over the last 18 months to tackle the eurozone crisis. Some measures are aimed at helping solvency, such as the bailouts of Greece, Portugal and Ireland, whereas others are aimed at helping liquidity such as the European Central Bank's (ECB) liquidity operations. In this issue we try to set out a clear overview of the nature and scale of the problems.

Solvency

Solvency concerns arise when governments cannot guarantee to honour their liabilities essentially when the government's total debt exceeds its resources. A common way of analysing government solvency is through the debt/economic output (GDP). Whilst this ratio is useful, it does not take into account the full picture as many liabilities that have government backing are indirect and not explicit.



Source: Trading Economics

There are two main ways to resolve solvency issues when finance markets refuse to continue to fund the liabilities. The first (and catastrophic) is for the government to default on the liabilities, and the second is for an external body, such as the International Monetary Fund (IMF) to subsidise the liabilities.

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Liquidity

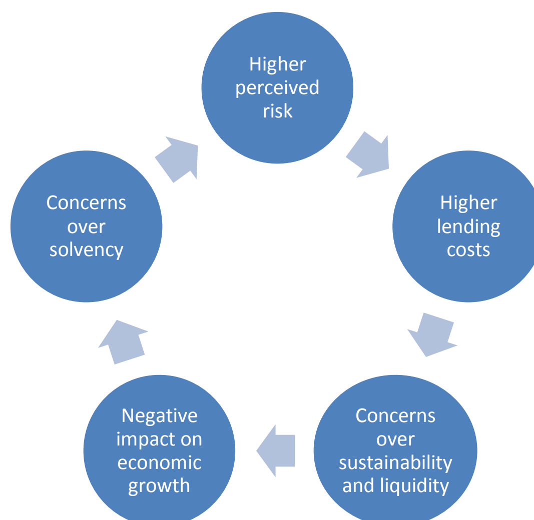
Liquidity concerns can arise when governments are solvent but have cash flow problems. This can cause problems if governments need to roll over existing debt and cannot finance this through traditional means, or cannot fully fund their policy programmes such as welfare benefits. A relatively straightforward way of resolving this issue is for the central bank to step in and provide the government with liquidity until the cash flow problems are resolved. Assuming the government is solvent, the central bank is not adding credit risk to its balance sheet. A common way of viewing liquidity is the budget balance of each government. A negative budget balance is where government expenditure exceeds revenues from taxation, which is funded through issuing government bonds (thereby increasing the government's overall debt).

Country	Budget balance 2011	Budget balance 2012
Germany	-2.1	-2.4
France	-5.9	-5.3
Italy	-3.8	-1.8
Spain	-6.5	-4.8
Portugal	-6.2	-5.7
Greece	-8	-6.5

Source: Morgan Stanley estimates as at September 2011

Solvency or liquidity?

The two points appear to be separate but can become difficult to distinguish when confidence in the government's solvency leads to illiquidity and, as shown below, a cycle appears. To illustrate the importance of keeping government bond yields at sustainable levels, Spain's Ministry of Finance estimated that for each 1% sustained rise in the ten-year bond yield, it would have a negative 0.3 to 0.5% per annum impact on the country's growth rate for the following three years. So far, the eurozone has been able to manage this cycle but not escape from it.



The eurozone experience

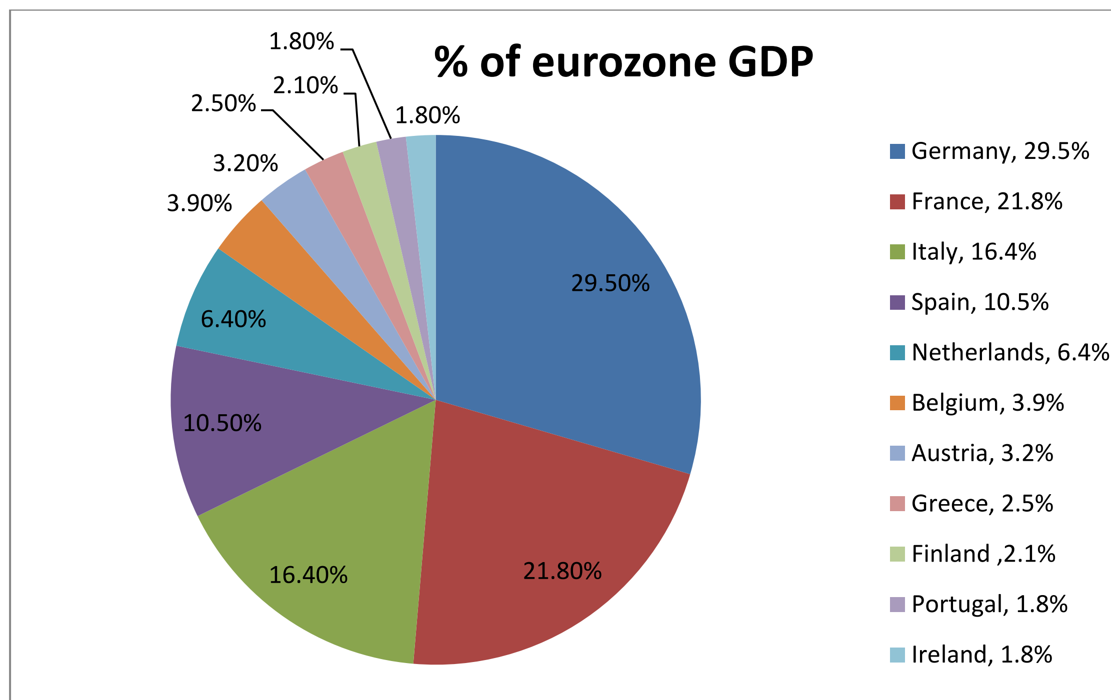
According to the debt/GDP ratio, only Greece and Italy are insolvent in the eurozone. However, the lack of confidence throughout the region has led to the above cycle taking hold. The ECB, as the region's central bank, would usually act as the circuit breaker when the perceived risk increases. However, due to its concern over its mandate and desire to remain non-political, the ECB has tried to resist interference unless markets reach a distressed level.

Italy and Spain are crucial in the solvency vs liquidity argument

Italy and Spain are crucial markets in the eurozone as they are too big to save and too big to fail. They make up nearly 27% of the eurozone's economic output.

Italy's ten-year bond yield is at 5.8% and Spain's at 5.2%, which is over 3% higher than Germany and their price correlation suggests they have similar issues. However, their issues are clearly different.

Italy has an apparent solvency issue with a large stock of existing debt. This is nothing new; Italy's debt/GDP ratio has been over 100% since 1990. They also have the common problem that the majority of the €1,800bn government debt is held by non-Italians meaning they rely on foreign investors to fund their liabilities. Despite the high levels of debt, Italy's budget balance is significantly better than other eurozone members and is expected to be balanced by 2013/14. Italy also suffers from a weak government which undermines their ability to tackle the problems.



Source: UBS

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Spain has an apparent liquidity issue with a high negative budget balance. They entered the credit crunch with the highest current account deficit (in $) behind the US. Their heavy reliance on construction in the '00s and subsequent property crash has pushed the country's unemployment rate to over 21%, which is compounded by a high relative cost of labour. However, Spain has the lowest debt/GDP ratio of the major eurozone nations.

In spite of their clear differences, their problems have been viewed collectively and the eurozone crisis has rumbled on without decisive action. The loss of confidence across the eurozone is clear to see.

The ECB - one solution to two problems?

We have discussed potential solutions to the wider eurozone crisis in previous Managing Wealth Express articles but there are immediate actions that could be taken by the ECB to help Italy and Spain's current position.

The ECB is the eurozone's central bank and is responsible for monetary policy in the region. Its balance sheet has grown from €750m at the start of 2004 to over €2 trillion at the end of August 2011 following a number of unconventional initiatives introduced in the last few years. The ECB is mainly funded through its role of printing euro banknotes. Its balance sheet is therefore able to expand with few restrictions. The main constraints to the expansion of the ECB balance sheet involve inflationary and reputational pressures, neither of which is currently problematic.

The ECB has so far acted in line with politicians - reactive rather than proactive, and only offered solutions when faced with clear systemic risk. The ECB is the only credible European institution that has the capability, independence and resources to improve market confidence without substantial political reform. Despite its goal of remaining non-political, it has become involved with the purchase of peripheral government bonds on the secondary market and the provision of extra liquidity to the banking sector. These measures both feel temporary and the ECB could step up its bond purchases (effectively quantitative easing) and liquidity provisions substantially to help give a confidence injection for wary investors.

The ECB is effectively capitalised by the eurozone governments, with its largest member being Germany. Therefore, in the unlikely event that the ECB runs into problems, such as a substantial loss in credibility or write down in capital, again it would be Germany which would be left with a very difficult decision to recapitalise the ECB, exit the euro, or accept higher inflation through printing substantial quantities of euro banknotes.

What does this mean for investment markets?

The recent fall in equity prices has largely reflected the expected slowdown in global economic growth, especially in the West. Bank share prices have been especially hard hit as uncertainty prevails around the eurozone debt markets. We would suggest equity markets have taken into account an orderly Greek default and slower global growth. However, the risk of severe pressure on Spain and Italy or an implosion of one of the large banking groups is not priced in. Whilst improbable, it is a risk that should not be discounted if politicians and central bankers cannot agree a long-term solution.

Equity markets look far better value than government bond markets. However, corporate bond markets are starting to look more attractive again, especially the financial sector. The Invesco Perpetual Corporate Bond fund has 40% of the fund invested in bank debt. The fund yields nearly 6% as at mid-October, which looks appealing compared to yields in other bond markets. Whilst the risk of a larger banking crisis is still there, many of the banks that the fund has invested in, such as Lloyds and Barclays (its top two holdings) have spent the last couple of years substantially rebuilding their balance sheets to create a safer business to lend to.

Conclusion

In hindsight, many of the eurozone's current problems could have been avoided if politicians and central bankers had acted quickly and decisively. The initial problems of liquidity or solvency have converged into a larger problem of confidence. If a level of confidence does return to the eurozone, Spain's liquidity problems and Italy's solvency problems can be resolved by a more active ECB. Despite the continuing problems in the Eurozone, good opportunities remain for patient investors.

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