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The Eurozone Crisis: Four Potential Scenarios

The following is a summary of the views of Mike Story, Economist at Western Asset Management.

- Greece and Portugal are insolvent. Both are in inescapable debt traps, which will lead to significant haircuts.
- Spain and Italy are solvent but illiquid.
- Ireland is making progress but is not systemically important.
- Spain and Italy are the linchpins.
- We are stuck in a bad equilibrium in which liquidity determines insolvency. Liquidity provision can buy time. The line between liquidity and solvency issues has become blurred.
- Despite undercapitalisation and funding strains, this is not a banking crisis. This crisis stems from flaws in Europe's monetary union.
- The only lasting solution is some kind of fiscal union, which could encompass a number of measures, such as Eurobonds, a fiscal transfer mechanism and/or synchronisation of bank regulation. Fiscal integration would involve stronger, more solvent countries helping weaker, less solvent countries.
- Fiscal integration would be designed to correct a flaw in the European monetary union: diverging business cycles within eurozone countries. Fiscal integration is needed to smooth out those business-cycle differences.
- The fate of fiscal integration rests with Germany. Germany needs to decide to commit.

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FOUR POTENTIAL SCENARIOS TO THE CRISIS

Scenario 1:
No Eurozone Restructuring

- This is the most optimistic scenario. All 17 members remain within the eurozone. "Golden rules" — balanced-budget amendments — are agreed to, leading to increased fiscal discipline. (Germany already has such a provision. France is now talking about it, and Spain and Italy are moving toward adoption of balanced-budget amendments).
- Enforcement of the Stability and Growth Pact is strengthened.
- The "golden rules" and Stability and Growth Pact changes are catalysts for the implementation of a fiscal union.
- Greece and Portugal default (70% haircuts) but remain within the eurozone.
- The outcome: Risk premiums collapse, significant risk-on focus.

Scenario 2:
Orderly Eurozone Restructuring

- In this scenario, policymakers (European Central Bank officials and European finance ministers) battle the market in an effort to ensure stability.
- "Golden rules" are not a sufficient catalyst for a fiscal union that would keep the eurozone together. Fiscal integration occurs, but only when Greece and Portugal are cast out as part of a bargain. Defaults are negotiated.
- Spain and Italy are ring-fenced.
- Outcome: risk premiums volatile but trend lower, gentle risk-on environment, bank subordinated debt potentially impaired but better than market pricing, on a voluntary basis.

Scenario 3:
Disorderly Eurozone Restructuring (unlikely, but possible)

- Policymakers are reactive, not proactive.
- Greece and Portugal give up on austerity, and they default.
- Alternatively, Germany resists further support.
- The ECB increases purchases of Spanish and Italian bonds to buy time for fiscal integration, which occurs after crisis conditions are reached.
- Liquidity provision prevents an outright implosion.
- Outcome: Risk premiums soar but ultimately recover (though they remain above long-term averages); risk-off eventually returns to risk-on; another 2009 situation after 2008 situation; bank subordinated debt impaired (justifying market pricing).

Scenario 4:
Eurozone Implosion (extremely unlikely)

- A Lehman-like scenario occurs in which things spiral out of control and emergency policy responses fail to materialise. Events occur so rapidly that policymakers are unable to respond quickly enough.
- This scenario is extremely unlikely, as so far policymakers have responded (e.g., ECB debt purchases, Italian and Greek austerity, temporary European Financial Stability Facility, permanent European Stability Mechanism).
- Outcome: Risk premiums soar, bank subordinated debt wiped out, severe risk-off environment.

The rational decision for Greece would be to stay in the European monetary union.

- If Greece abandons the euro, it would forfeit membership in the European Union, losing the advantages of free-trade treaties and other political, social and economic benefits of EU membership. Greece would also lose geopolitical influence (especially relevant, given the Cyprus issue).
- If Greece leaves the eurozone, the Greek economy would not rapidly rebound and could even experience a severe depression. Greek banks would go deeper into negative territory, requiring strict capital controls to prevent outflows.

The rational decision for Germany would be to support the weaker eurozone countries through fiscal integration, but the German public is overwhelmingly opposed to such a move. Will Germany make the rational decision?

The state of the euro now:

- We are looking for a gradual depreciation of the euro.
- We are underweight the euro in European and global portfolios because the eurozone crisis could lead to an abrupt depreciation if the ECB decides to rush in. The euro has already depreciated, and markets anticipate that the ECB will implement a 50 basispoint cut by year-end (the ECB had previously been raising rates).

Conclusion: The crisis will rumble along until the unimaginable is imagined: namely, fiscal integration. Optimist versus pessimist question: Is this a liquidity event or a solvency event? And if it's the latter, what is the stamina of official liquidity provision?

All views are as of 16 September 2011 and are subject to change.

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