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Special Commentary

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What Happens if Spain or Italy Leaves EMU?

Executive Summary

In the second of two special reports on the European debt crisis, we examine the implications of potential sovereign default and exit from European Monetary Union (EMU) by Spain and Italy, which are the largest of the so-called peripheral European countries that have been adversely affected by the debt crisis. Although foreign banks have reduced their exposure to these countries over the past few years, banks in Spain and Italy have increased their holdings of domestic government debt over that period. In a worst-case scenario, expectations of sovereign default and EMU exit by Spain or Italy could become self-fulfilling. In that event, the banking system of the affected economy probably would collapse due to the significant holdings of domestic government debt that default would make worthless. Due to substantial amounts of cross-border lending, banks in other European countries, especially in France and Germany, would likely suffer large losses as well. The indirect effects on the American banking system and economy could also be significant.

The worst-case scenario of EMU disintegration is not our base-case view, although its probability is not insignificant either. What seems more likely—in our view the probability is somewhat above 50 percent—is that European leaders will do enough to prevent a disintegration of the EMU. However, they probably will not do enough in the short term to completely "solve" the European debt crisis. Reforms that would "fix" EMU would include further fiscal integration, government financing via so-called eurobonds, bank recapitalization, bank regulation, supervision and deposit insurance at the supra-national level, and economic and labor market liberalization in highly indebted countries. In our view, however, domestic political constraints will make it difficult for EU leaders to entirely embrace this complete menu of reforms, at least for the foreseeable future. Consequently, the European debt crisis, which has been waxing and waning for more than two years, will probably continue to fester for some time.

Default by Spain or Italy Would Be Devastating

A Greece exit would significantly raise the probability that other countries would follow suit.

In a recent report, we wrote about the implications to Greece if it decides to pull out of EMU and abandon the euro.[1] As we indicated in that report, abandonment of the euro, which would go hand-in-hand with default by the Greek government, would impose significant costs on different sectors of the Greek economy. A disorderly default by Greece would be messy, but it need not be inherently destabilizing for the global financial system as long as the Hellenic Republic could be completely "ring fenced." However, we think it is unlikely that Greece can be completely "ring fenced." As we argued in our first report, "a roadmap for exit would have then been established, and investors would wonder whether other countries would be tempted to leave as well." Exit from EMU by Greece would significantly raise the probability that other countries, especially Ireland, Italy, Portugal or Spain, would eventually follow suit.

[1] **See our special report entitled "Implications of a Euro Exit to Greece" (May 29, 2012), which is available upon request.**

Together we'll go far

Although the Maastricht Treaty, which established EMU, does not provide a legal mechanism by which a subset of EMU members can "kick out" another member, market forces could essentially force a country to exit EMU. Investors know that a country that exited EMU would have its own central bank that would initially lack the inflation-fighting credibility of the European Central Bank (ECB).[2] Therefore, investors would demand an inflation risk premium, which could push up government bond yields to unsustainable levels. The government would then be forced to default, which, as we describe in more detail below, could lead to the collapse of the domestic banking system. Faced with the prospect of a painful depression, the government could reason that an exit from EMU was preferable to remaining within the monetary union because abandonment of the euro would offer the possibility of the country eventually exporting its way back to some semblance of prosperity via currency depreciation. In other words, the expectations of an EMU exit could become self-fulfilling.

Outstanding Greek government debt pales in comparison to that of Spain and Italy.

If Spain or Italy defaulted on its debt and followed Greece out of EMU, the global financial fallout could be significant. The outstanding amount of Greek government debt totals about €350 billion, which pales in comparison to the comparable numbers for Spain and Italy (Figure 1). As we describe subsequently, a default by the Spanish or Italian governments would set off a chain of events that could be devastating for the global economy.

Figure 1

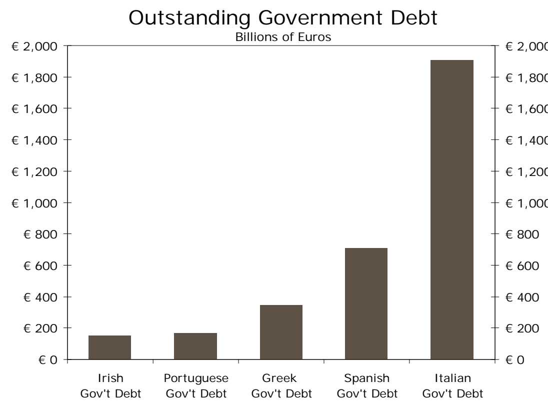
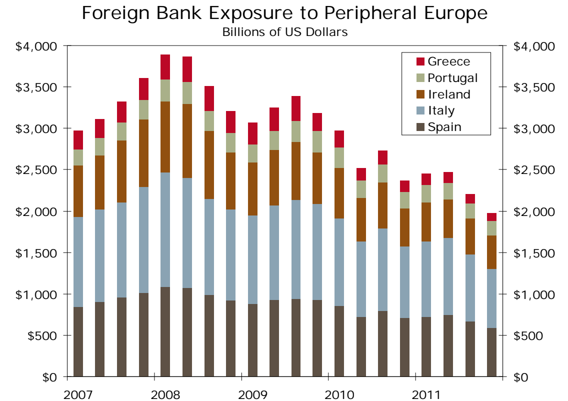


Figure 2



Source: IHS Global Insight, Bank for International Settlements and Wells Fargo Securities, LLC

Spanish and Italian Banks: Chock Full of Government Debt

The vast majority of foreign bank exposure to peripheral Europe is concentrated among European banks.

Data from the Bank for International Settlements (BIS) show that foreign banks have reduced their exposure over the past few years to the so-called peripheral European countries (*i.e.*, Greece, Ireland, Italy, Portugal and Spain). In Q1-2008, the exposure of foreign banks to peripheral Europe totaled nearly $4 trillion (Figure 2). By Q4-2011 (latest available data) that exposure had dropped by one-half to $2 trillion, with Italy and Spain accounting for two-thirds of that total exposure. As might be expected, the vast majority of foreign bank exposure to peripheral Europe is concentrated among European banks, which accounted for 90 percent of that exposure at the end of last year (Figure 3).

The good news is that lending by European banks to peripheral European countries is broad-based and not concentrated in one sector. At the end of 2011, the value of European bank loans to banks in peripheral Europe exceeded $300 billion, which was more than the $266 billion of peripheral European government bonds that European banks owned (Figure 4). In addition,

[2] Consider Spain as an example. Before the country entered EMU in 1999, monetary policy in Spain was conducted by the Bank of Spain. Between 1980 and 1998, inflation in Spain averaged 7.6 percent per annum. However, the country's annual average inflation rate dropped to only 2.9 percent between 1999 and 2011.

loans by European banks to the corporate sectors in peripheral European countries totaled nearly $1.2 trillion.

Figure 3

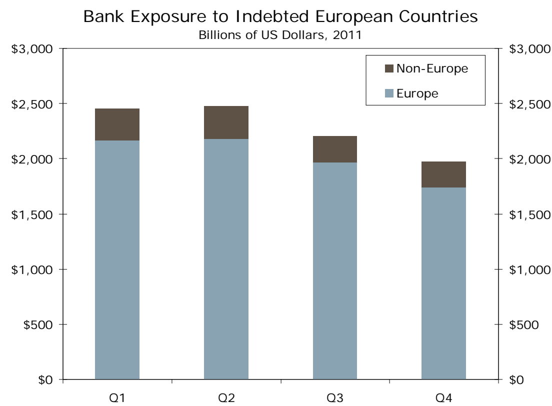
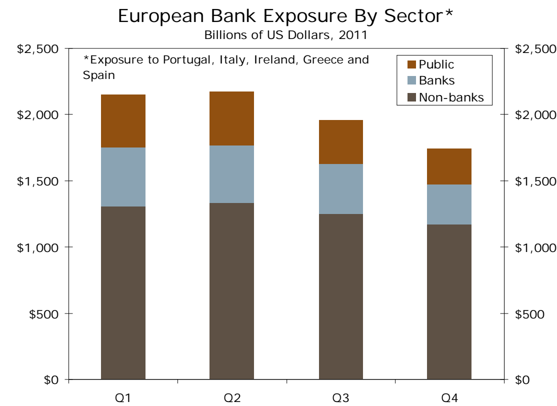


Figure 4



Source: Bank for International Settlements and Wells Fargo Securities, LLC

Default by either Spain or Italy would have a significant adverse effect on European banks.

The bad news is that $266 billion worth of sovereign debt holdings is not an insignificant amount. A default by either the Spanish or the Italian government, should one occur, would have a significant adverse effect on European banks. Not only would European banks be directly affected by the default—they would need to write down some portion of the bonds they own—but there would also be indirect effects because a default would probably lead to the collapse of the respective banking system in either Spain or Italy.

If, as Figure 4 shows, foreign banks are reducing their exposure to Spanish and Italian government bonds—foreign holdings of the combined debt of these two governments dropped from more than $600 billion in 2009 to about $250 billion at the end of 2011—then how have those governments financed their deficits over that period? In the case of Spain, Spanish financial institutions, largely banks, have been the residual purchaser of Spanish government bonds (Figure 5). At the end of 2008, Spanish banks owned about €100 billion worth of Spanish government bonds. By the end of last year, the value of those holdings exceeded €200 billion.

Figure 5

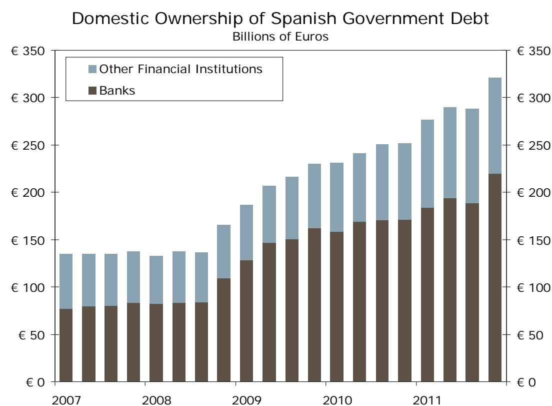
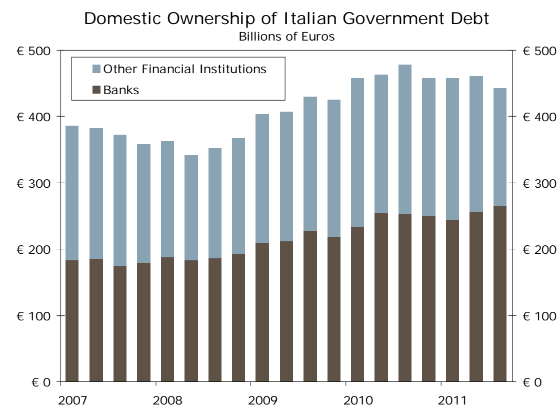


Figure 6



Source: Bank of Spain, Bank of Italy and Wells Fargo Securities, LLC

Moreover, our data series ends in December 2011, so Figure 5 would not show the full effects of the ECB's long-term refinancing operations (LTROs). In the two LTROs that were conducted in December and February, the ECB extended about €1 trillion worth of three-year financing to

banks in the Eurozone. Spanish banks reportedly used some of the cheap financing they received from the ECB to buy higher-yielding Spanish government bonds. Therefore, it is highly likely that Spanish banks own more than the €219 billion worth of Spanish government bonds that were reported on their books at the end of Q4-2011.[3]

The ownership of Italian government bonds by all Italian financial institutions has been more or less stable over the past year or so, although the amount of bonds owned by Italian banks has crept up over that period to total €265 billion in Q4-2011 (Figure 6). It is also likely that Italian banks own more Italian government bonds today than they did a few months ago due to the ECB's LTROs. In sum, both Spanish and Italian banks own a sizeable amount of their respective government's debt.

Global Financial Fallout from Sovereign Default

France and Germany together account for about three-quarters of total European bank exposure to peripheral Europe.

Default by either the Spanish or Italian governments would deal a fatal blow to their respective banking system. A sharp curtailment of credit would follow that would cause the respective economy to plunge into a very deep and painful downturn. Many businesses would fail. Foreign banks, especially those in other European countries that have significant exposure to the corporate and banking sector in the affected economy would suffer heavy losses that could outweigh the direct losses associated with the defaulted government bonds on their balance sheets. The French and German banking systems would come under stress because France and Germany together account for about three-quarters of the total exposure of the European banking system to peripheral European countries (Figure 7). Although the vast majority of French and German bank lending to peripheral European countries is to the corporate and the banking sectors in those five economies, deep recessions that would be triggered by a sovereign default would lead to a spike in non-performing loans among French and German banks.[4] In a worst-case scenario, some banks in large European countries could also collapse.

Figure 7

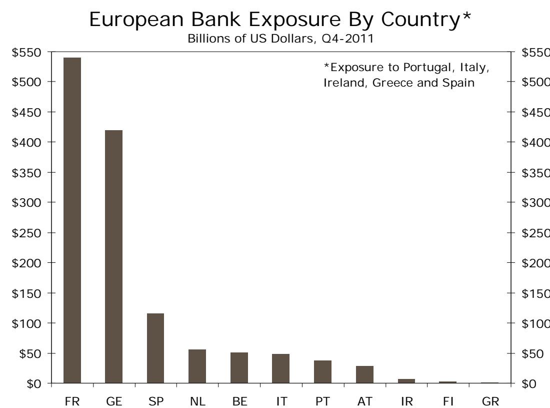
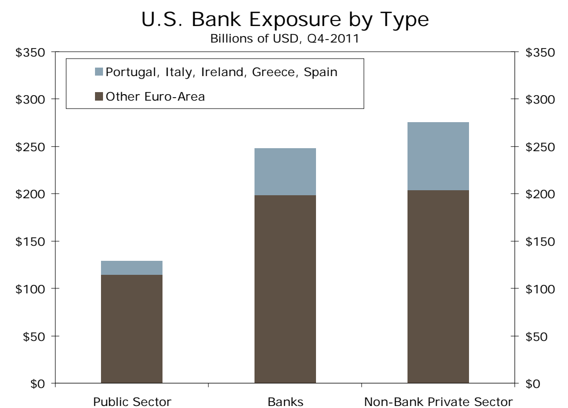


Figure 8



Source: Bank for International Settlements and Wells Fargo Securities, LLC

The exposure of the U.S. banking system to the five peripheral European countries is rather limited, with only $14 billion outstanding to the public sector, $49 billion to the banks and $72 billion to the non-financial business sector at the end of 2011 (Figure 8). No doubt the exposure of American banks to these five peripheral European countries is even smaller at

[3] If the holdings of non-bank financial institutions (e.g., pension funds and insurance companies) is included, then the exposure of the Spanish financial system to Spanish government bonds at the end of 2011 rises to €321 billion.

[4] Of the $541 billion worth of exposure that French banks had to peripheral European countries at the end of 2011, about 18 percent was to the public sectors in those economies. Lending to other banks and to the non-financial business sector accounted for 13 percent and 70 percent, respectively. The comparable figures for the German banking system were 20 percent (public sector), 27 percent (other banks) and 53 percent (non-financial business sector).

present than it was at the end of last year. However, U.S. banking exposure to non-peripheral European countries exceeded $500 billion at the end of 2011, with nearly $200 billion outstanding to banks in those countries. The direct effects on the American banking system of a sovereign default in either Spain or Italy would be rather limited. However, the European banking system would be severely affected by the default, and these shock waves would then be indirectly transmitted to the American banking system and economy. In sum, a sovereign default and exit from EMU by either Spain or Italy could be another "Lehman moment."

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Which Way Forward for EMU?

There are a number of upcoming events that will help to determine the future direction of EMU. Perhaps the most closely watched will be the Greek parliamentary elections on June 17. If Greek voters elect a government that favors reneging on the austerity measures that were approved by the previous government, the probability of Greek exit from EMU would rise significantly. The European Union (EU) and the IMF would probably withhold bailout funds that would make a Greek government default and exit from EMU likely. Even if Greek voters elect a pro-austerity government on June 17, the European sovereign debt crisis would be far from being fixed. After the Greek election, the next major event will be the EU summit on June 29-30 at which some long-run solutions to the crisis appear to be on the agenda. A disappointing summit would lead to further financial market tensions as investors would infer that EU leaders lack the political will to fix the problem.

In that regard, the best-case scenario would be agreement among EU leaders to enact, or at least begin to enact, the policies that will solve the long-simmering debt crisis in the long run. However, we judge the probability of the best-case scenario being realized over the next few months to be rather low. Any long-term "fix" will require the commitment of more resources, which is probably politically difficult to deliver at present.

In a worst-case scenario, EMU begins to unravel, which, as described above, could lead to a "Lehman moment." This scenario could be triggered by an election outcome in Greece whereby an anti-austerity government comes to power, which then leads to default and exit from EMU. Government borrowing costs in Spain and Italy would spike as investors question the ability of those countries to remain within EMU. Eventual default and EMU exit by Spain and Italy then follow. This scenario could also come about if there is a complete breakdown in cooperation at the upcoming EU summit. Investors, convinced that EU leaders lack the political courage to reform EMU, dump Spanish and Italian government bonds. Although we judge the probability of this worst-case scenario to be not insignificant, it is not our base-case scenario.

In our view, the most likely scenario (*i.e.*, the one with more than 50 percent probability) is one in which EU countries continue to muddle through. In the past, EU leaders have done enough to extinguish the immediate crisis, at least temporarily. We believe that EU leaders understand the implications, not only for the Eurozone but for the entire global economy, of sovereign default and EMU exit by a number of large economies. However, it appears that domestic political constraints make it difficult for leaders to enact the full set of reforms that are needed to fully extinguish the crisis.

Domestic political constraints make it difficult to enact the full set of reforms needed.

In that regard, what would be needed to adequately reform EMU, thereby finally "solving" the European debt crisis? In our view, more fiscal integration needs to be achieved among the member states of EMU. That is, more resources need to flow from national capitals to a centralized authority in Brussels. That way, transfers among different EMU member states can be made more quickly if one of the countries encounters economic difficulties. Second, migration to so-called eurobonds, by which governments jointly guarantee each others' liabilities, or at least some significant portion of them, would be desirable.

In addition, the European Stability Mechanism (ESM) should be broadened to allow it to recapitalize banks, if needed, rather than simply providing a bailout fund for governments. Speaking of banks, responsibility for banking supervision and regulation should be transferred to the supra-national level rather than leaving it in the domain of individual governments, and bank

deposit insurance should also be provided at the centralized rather than the national level. Last, but certainly not least, the countries that are experiencing debt problems today need to undertake the structural supply-side economic reforms to their economies and labor markets that will enable them to grow in the long run. It is very difficult for a government to stabilize its debt-to-GDP ratio, which lies at the heart of solvency, if the economy is unable to grow in the long-run.

EMU will not be truly "fixed" until its structure is radically revamped.

EMU member states may slowly put in place some of these reforms, and we will be watching the upcoming EU summit closely for signs of progress. However, because the reforms listed above are so comprehensive, it likely will be difficult for EU leaders to embrace the entire menu at one time. Partial progress may be greeted by some relaxation of market tensions. However, EMU will not be truly "fixed" until its structure is radically revamped. Therefore, we think it likely that the European debt crisis, which has been festering for more than two years, will continue to rear its ugly head from time to time.

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