STRATEGY ECONOMICS

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SPAIN'S GAME OF CHICKEN WITH THE MARKETS WON'T END HAPPILY

SUMMARY

- **Spain does not want to request aid from the ECB – it is politically humiliating.**
- **It is engaged in a game of chicken with the market.**
- **But in game theory, the chicken game ends up in a car crash.**

In the next few days and weeks, there is one simple question everyone in the markets is going to want to know the answer to. When is the Spanish Prime Minister Mariano Rajoy going to press the button on the Spanish bail-out?

In the summer, the President of the European Central Bank Mario Draghi announced he would do 'whatever it takes' to save the euro. And it turned out that he meant it. Stretching the definition of preserving price stability in ways that even the former Federal Reserve chairman Alan Greenspan, who defined his job as keeping the stock market happy, might have found over-ambitious, Draghi has taken it upon himself to keep bond yields in the peripheral, highly-indebted euro-zone countries under control.

In practise, that means the ECB will step into the markets and buy the bonds of peripheral countries directly – and in unlimited quantities if necessary. There is a catch, however. It won't happen until the country involved formally requests assistance.

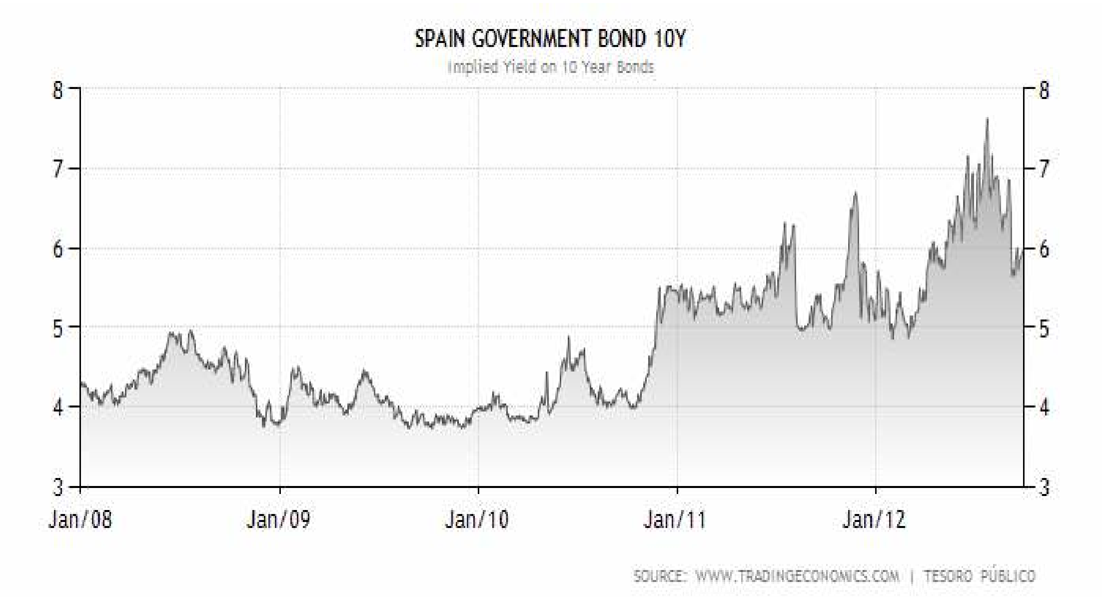
Ever since the ECB's announcement, the markets have been expecting the Spanish PM to make the call. But when is it going to happen? This Thursday. Next week? Next month? No one quite knows.

In fact, Spain is engaged in a complicated dance with the markets. In game theory it is know as 'chicken'. And it rarely ends happily.

One: Spain Does Not Want to Request Aid

Investors, naturally enough, want the Spanish to go ahead and ask for assistance. The ECB's intervention amounts to quantitative easing by another name. Whether that will actually help the euro-zone economy any more than it has helped the American, Japanese or British economies, where central banks have been printing money like crazy for several years now, remains to be seen.

But one thing is for sure. It helps the asset markets. Gold, equities and bonds all do well when money is pumped into the economy. There is nothing for investor not to like about that.



But for Rajoy – the man who will have to make the call – it is almost certainly going to be a disaster. He will want to avoid a bail-out if at all possible. There are three reasons for that.

One, he won power at the last election pledging not to ask for help from his partners in the euro-zone. To go back on that now would be humiliating. Breaking a promise, particularly such a high-profile one, is seldom good for a politician's career prospects.

Two, this month has seen the rise of independence protests in Catalonia, a region where there had always been a strong movement for full independence. That is a worrying omen for the government in Madrid. It suggests that some regions may believe they can escape ECB supervised austerity simply by breaking away. Does an independent Catalonia have to repay Spain's debts? No one really knows. But this much is clear. Asking for a bail-out will put pressure on the unity of what has always been a fractious country.

Three, Rajoy must know what happens in the script from here. Every national leader who asks for a bail-out gets wiped out at the next election. It happened in Greece and Ireland and there is no reason why it shouldn't happen in Spain as well. Two of Spain's regions – the Basque Country and Galicia – are due to hold elections on October 21st. A hammering in either – and particularly in his home region of Galicia – is the last thing the Prime Minister needs.

You don't need much more incentive than that. A bail-out might make economic sense. But the politics are toxic.

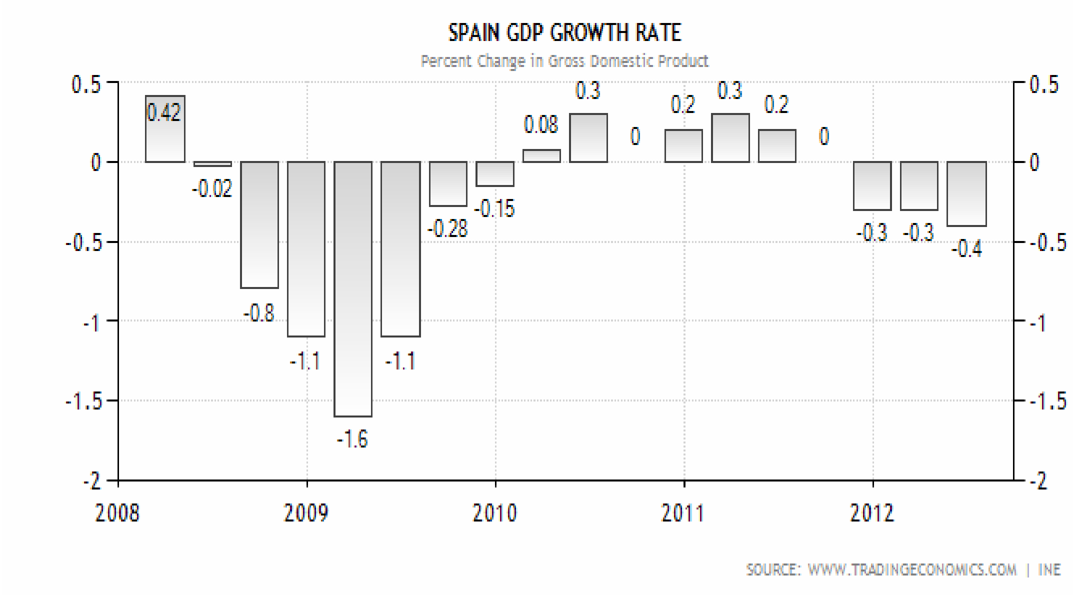
Two: The Chicken Game Ends Up With a Car Crash

There is chance the Spanish PM may get away with never requesting aid.

Why? Because bond investors know that the ECB is standing ready to intervene massively as soon as Rajoy pulls the trigger. You don't want to be stuck shorting the Spanish markets when the ECB suddenly wades in on the other side of the trade.

Game theory – the branch of economics that is actually most useful for analysing the twists and turns of the euro crisis – has this scenario covered. It is known as 'chicken'.

In the 'chicken game', two cars drive towards each other at high speed. Both drivers assume the other will swerve out of the way – otherwise they will crash into each and die. After all, the costs of swerving are trivial, and the costs of a collision are very high. So you just figure the other guy will get out of the way first. He would be crazy not to.



Something very similar is happening in Spain right now. Both the markets and the politicians are assuming the other side will swerve out of the way first. Rajoy may calculate the bond traders will blink. After all, if they don't they will get crushed by the ECB. Likewise, the traders will assume Rajoy will blink. If he doesn't, he may face a sudden and catastrophic banking collapse that will plunge the country into a calamitous recession.

What happens in the 'chicken game'? Both cars end up smashing into each other – even though that is the worst possible outcome for everyone.

There is a real risk that is precisely what we will see played out in Spain over the next month. Rajoy assumes the bond markets will back down, and the bond markets assume that the Spanish PM will back down. And both sides end up in a nasty collision.

If it happens, it won't be pretty. One of the main ratings agencies may downgrade Spanish debt to junk. Money might start to flee out of Spanish banks. The bond yield might start to spiral uncontrollably upwards. Even if the ECB does intervene, by them it may be too late to prevent a meltdown. Mario Draghi has laid out a plan to rescue Spain. But it still needs Rajoy to make that call. And it would be rash to assume that it will actually happen – or that it will happen soon enough to prevent a meltdown.

- Matthew Lynn
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Forecasts

The UK Economy

	2012	2013	2014
Growth:	-0.2%	0.9%	1.5%
Inflation:	3.1%	2.9%	2.7%
Unemployment:	9.2%	10.2%	9.5%

The EuroZone Economy

	2012	2013	2014
Growth:	-0.7%	0.2%	1.2%
Inflation:	2.0%	1.8%	1.8%
Unemployment:	9.4%	9.2%	9.4%

The German Economy:

	2012	2013	2014
Growth:	-0.5%	1.0%	1.4%
Inflation:	2.0%	2.2%	2.4%
Unemployment:	6.6%	6.8%	6.9%

The French Economy:

	2012	2013	2014
Growth:	-0.7%	1.0%	1.0%
Inflation:	1.9%	2.3%	2.6%

Unemployment:	8.9%	8.7%	8.8%

The Italian Economy:

	2012	2013	2014
Growth:	-2.5%	-1.7%	0.1%
Inflation:	2.1%	2.0%	2.1%
Unemployment:	8.9%	10.1%	10.7%

The Spanish Economy

	2012	2013	2014
Growth:	-2.0%	-0.5%	0.6%
Inflation:	1.9%	2.1%	2.3%
Unemployment:	22.3%	24.8%	25.6%

Exchange Rates

	2012	2013	2014
Euro/$1:	1.15	1.10	1.21
Pound/$1	1.60	1.71	1.78

Commodities:	2012	2013	2014
Gold:	1,900	2,500	2,600
Brent Crude:	125	140	150

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