Fiddling while the Periphery Burns

After more than a year since the European debt crisis began, officials have still failed to resolve it. They raised expectations for a “grand bargain” only to crash them on the shoals of political reality. The March 24-25 Summit was to finally provide closure and yet the situation remains fundamentally unresolved.

Greece and Ireland
Greece is no closer to coming back to the markets than it was a year ago. In fact, the sovereign crisis has produced a banking crisis. Greek banks have more than 50 bln euros in government bonds and the failure of the aid package last May to stabilize interest rates pressures domestic institutions. Shrinking deposit base and worsening loan losses are forcing the country’s banks to increasingly rely on the European Central Bank for financing. The central bank is expected to soon ask parliament to approve 30 bln euro in new guarantees for the banks.

The lower interest rates and the extended tenure of the assistance agreed earlier this month in exchange for 50 bn euro in asset sales by the Greek government is worth about 2.5% of GDP. It does little to ease the Greece’s debt burden. It is looking increasingly likely that if there is not greater burden sharing soon, the country may need a second assistance package.

The same is broadly true of Ireland, though it was the banking crisis that led to the sovereign crisis. The full dimensions of the banking crisis are still not fully appreciated. The fact that last year’s stress test found no Irish bank in need reveals more about the stress test than the condition of the Irish banks. This year’s test will be different.

The stress test results are expected on Wednesday, March 31. The test is being led by a unit of Blackrock Solutions, alongside French and Italian regulators and the Boston Consulting Group. The results will be reviewed by the IMF, European Commission and the ECB. There seems little doubt among observers that Irish banks need more capital and estimates range from about 25 bln euros to 50 bln euros.
One bank, Anglo-Irish, which has been nationalized, will not be subject to a stress test, but may need 3-4 bln euros more, on top of the 29 bln already doled out. Overall the Irish government has injected a little more than 46 bln euros into the banks and has already exhausted around 80% of the 35 bln euro fund set up late last year as part of the larger aid package.

Irish banks remain heavily reliant on the ECB for funding. Their borrowings in February stood at nearly 117 bln euros, a 38% increase from a year ago. On top of this, borrowing from the Irish central bank (Exceptional Liquidity Assistance) has grown five-fold to 70 bln euros.
The ECB wants to wean banks off of its liquidity teat, but most European officials want to interpret the debt crisis as one of liquidity not solvency. This means that it is incumbent upon the ECB to provide a new facility for longer-term liquidity. A new facility could be announced in the coming days. In effect, it is likely to take direct control over the ELA function and though directly applicable for the Irish banks, may have wider relevance.

Iberia

Germany dithered last spring before acting and this contributed materially to the European debt crisis. Later in the year, German Chancellor Merkel began talking about burden sharing among bank bond holders and this help spark a run on Irish banks. Then when Irish officials wanted to renge on their promise to treat senior bank bond holders as depositors and guarantee them in whole, European officials, including ECB balked, though reports suggest even the IMF was more sympathetic to the Irish plight. The new Irish government will likely continue to push in this direction.

Leave aside the fact that Portugal’s debt-to-GDP ratio is lower than Germany’s, and the fact that the Portuguese economic contraction is deepening, the insistent pressure brought to bear on the minority government proved too much and led to its collapse.

Portugal’s debt management office estimates the government has about 4 bln euro on hand. It faces a 700 mln euro coupon payment and a 4.3 bln euro maturity in April. Before the collapse of the Socrates government, some observers expected the government to persuade domestic banks to buy the new debt issuance, with funding by the ECB.

While still possible, the obstacles create by the political vacuum, the rating downgrades, and the decision by LCH Clearnet that Portugal bonds will no longer be accepted as collateral, makes that course more problematic.

In any event, Portugal faces another, more difficult hurdle in June. Then has a coupon payment of 2 bln euros and maturities of almost 5 bln euros. Contrary to official denials, we have suspected Portugal cannot stand alone and will need assistance. The size of the package, like the Greece and Irish package is likely to provide funding for three years.

There are three components: sovereign bonds maturing and anticipated deficits, bank bonds maturing, and finally the new capital injections the banks will need after the stress tests. Estimates of the size of the package are around 70-80 bln euros.
Spain is next in line. Its size makes it particularly challenging for European officials. Spain is bigger than Greece, Ireland and Portugal put together. Spain’s world class banks (Santander and BBVA) have taken stakes in some of Portugal’s largest banks. However, the real challenge to Spain is home grown.

Many observers suspect that Spanish banks have yet to mark-to-market their property and construction loan portfolios. The cajas have taken control of 23 bln euros of property after defaults and some land prices have fallen by as much as 80% over the past four years. The central bank estimates that Spanish banks hold around 320 bln euros in property assets and (real estate and construction) loans.

In early March, the central bank estimated that banks will need to raise a little more than 15 bln euros to meet the new capital requirements by September, but can appeal for six month extension. Moody’s has said that the Spanish banks may need 50 bln euros, and private estimates, under stress scenarios, runs toward 80-100 bln euros.

Our analysis has shown a decoupling of Spanish bond performance from Portuguese bond performance. Investors need to continue to monitor the correlation between Spanish and Portuguese bonds or credit default swap prices. Tighter ECB monetary policy could squeeze Spanish households as nearly all mortgages are variable rather than fixed.

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European officials have spent a great deal of time and political capital in laying out the blueprint for the European Stabilization Mechanism that will replace the European Financial Stability Facility in the second half of 2013. European officials failed to agree on how the EFSF will be made more efficient so it can lend out more than 250 bln euros of the 440 bln guarantees, and still maintain its triple-A rating.

It is only after the ESM comes into existence do that top European officials think banks will be strong enough to share in the burden of addressing the sovereign and bank debt. There is a certain hubris involved with thinking it has that time. Voters and investors are not waiting.

There has been no closure, not just in Portugal, but in Greece and Ireland as well. Interest rates and risk premiums continue to trend higher. The political fallout is growing. Most pronounced has been Germany’s Merkel who has been hit with a number of setbacks in the first quarter. It is increasingly less clear that she has the political clout to get both houses of parliament to support her EU agreements.

With the CDU’s defeat in Batten Weurtemmbberg, and continued loss for Sarkozy’s UMP losses in local contests, the political focus shifts to Finland. The True-Finn Party, which is opposed to giving another cent to the EFSF or ESM, has risen to second place in opinion polls ahead of the April 17 national election. The strategy of protecting the creditors (largely European banks) at the expense of nearly all other

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stakeholders, including foreign taxpayers, makes questionable economic sense and dubious political sense. The longer it takes officials to find closure the more costly it will be.

Marc Chandler  
Global Head of Currency Strategy