Five Questions about Europe
Anil K Kashyap
http://faculty.chicagobooth.edu/anil.kashyap/
December 17, 2011

1. When will Greece default?

2. What stops bank runs throughout Europe?

3. Who buys Spanish and Italian debt?

4. How will peripheral countries grow?

5. What is Germany’s willingness to pay?
Greece must default

1. “Official sector estimates” finally concede no growth until 2013
2. Debt to GDP currently over 160. Even with the new program ratio will be over 120
3. Perpetual problems collecting taxes and implementing cuts
4. Limited public support for the pain associated with austerity
5. They are running out of cash
6. When the default comes the Greek banks will be broke
Figure 3: 50% Haircuts to SGIIP sovereign exposures, % Core Tier 1, by banking system

Source: EBA, Barclays Capital
Bank runs

1. Multiple potential triggers
   • Images of Greeks lining up to get money
   • Default of a counterparty when Greece does default
   • Concerns over a failed Italian bond auction
   • Definitive statement by Germany that their exposure is limited!

2. Need a full backstop
   • ECB can print money to do it
   • Germany can do it, at the risk of trashing its credit rating
Bank funding needs

Source: Morgan Stanley
ECB bank support

ECB Reliance: % of Banking Assets funded by ECB

% of banking assets funded by ECB

Source: ECB, Central Bank of Ireland, Morgan Stanley Research
Note: Time lags on data releases mean latest data not available for all countries
Credible assumptions for inflation, GDP growth and primary budget deficits in Italy imply that either the Debt-to-GDP ratio in Italy would increase sharply if Italian interest rates on 10-year government debt remained at the November 30 level of around 7 percent or Italy would lose access to the bond market.
Absent outside help to deal with runs, such as a pledge of fiscal support from Germany or an unlimited commitment by the ECB to buy bonds, there is no spending-and-tax plan Italy can announce that would be credible enough to hold its interest rates low enough to stabilize its Debt-to-GDP ratio.

Source: IGM Economic Experts Panel
www.igmchicago.org/igm-economic-experts-panel
Who buys Spanish and Italian debt?

1. Spreads for Italy over the Germany now exceed 500 basis points
2. Anemic growth prospects
SPAIN AND ITALY, 2012-14

CHICAGO BOOTH
The University of Chicago Booth School of Business
Ugly sovereign funding risk

Source: Morgan Stanley
Where does growth come from?

Exhibit 13
Competitiveness gap

Unit Labour Cost (1999 = 100)*

Less competitive

More competitive

1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010

Germany
Italy
Spain
Belgium
Portugal
Ireland
France
Greece

*Relative to 36 industrial countries; total economy
Source: Haver Analytics, Morgan Stanley Research
Barclays latest forecasts

<table>
<thead>
<tr>
<th></th>
<th>Real GDP % over previous period, saar</th>
<th>Real GDP % annual chg</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2Q11</td>
<td>3Q11</td>
</tr>
<tr>
<td>Euro area</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.1</td>
<td>0.0</td>
</tr>
<tr>
<td>France</td>
<td>0.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Germany</td>
<td>0.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Greece</td>
<td>-3.0</td>
<td>-2.4</td>
</tr>
<tr>
<td>Ireland</td>
<td>6.4</td>
<td>-4.5</td>
</tr>
<tr>
<td>Italy</td>
<td>1.2</td>
<td>-0.7</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>-0.2</td>
<td>-7.9</td>
</tr>
<tr>
<td>Spain</td>
<td>0.6</td>
<td>0.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1.6</td>
<td>1.6</td>
</tr>
</tbody>
</table>
Figure 9: Total potential commitments, % GDP – excluding program countries plus Italy & Spain

Source: Central bank data, Bloomberg, Dealogic, Barclays Capital
Germany’s willingness to pay?

1. ECB buys everything in sight and also repos against bad debt. ECB eventually recapitalized.

2. Germany accedes to “joint and several” guarantees for all euro area debts. Trashes its own credit rating.

3. Germany and France (and a few others) exit to form a new monetary union.