# Global Economics View

## Why Spain and Italy are under attack and how to defend them

- Spain and Italy are under attack in the sovereign debt markets
- The EFSF has neither the size nor the instruments to help
- Proposed instrument enhancement for EFSF adequate, but not in time
- Proposed size enhancement to €440bn woefully inadequate to fund Italy and Spain for an extended period
- This leaves only the ECB as lender of last resort and market maker of last resort for sovereigns
- The ECB should get guarantees from Euro area sovereigns for Securities Markets Programme purchases, or a guaranteed exit to the EFSF for them.

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# Spain and Italy under attack – and how to defend them

Spain and Italy are at risk of a market ambush, with their 10-year sovereign rates spiking to 6.46 percent and 6.26 percent, respectively, on 2 August 2011. Belgium too, with its 10-year spread at 1.98 percent, is now suffering from contagion from the periphery, and even France appears to be decoupling from core Europe, with its 10-year spread over Bunds widening to 76 basis points.

**EFSF: no guns and no ammunition**

The proximate reasons for this run on the Spanish and Italian sovereigns are, first, a failure to provide the European Financial Stability Facility (EFSF) on time with the necessary tools to intervene in the sovereign debt markets, and, second, a failure to provide the EFSF with the necessary financial resources even after it gets the right tools. Spain, Italy (and of course Belgium and France) are all mainly liquidity issues. Sovereign solvency concerns, although never completely absent, are low (and declining in the order of the countries mentioned).

**Governments are like banks: not safe against a run, even if sound**

**Therefore, governments need a lender of last resort and market maker of last resort**

But governments are like banks. They are always at risk of a sovereign debt run (the way banks are at risk of a bank run) because government assets (mainly the net present value (NPV) of future taxes and the NPV of future spending cuts) are long-term and highly illiquid, while its liabilities are shorter maturity and liquid. So like a bank, a sovereign needs a lender of last resort to provide funding liquidity or a market maker of last resort to provide market liquidity for its securities, even if it is fundamentally solvent, in the sense that its assets, if held to maturity, would cover its liabilities and any new obligations. In a one government/one central bank setting, the central bank is the lender of last resort and market maker of last resort for the government, as it is for banks. The Euro area has 17 sovereigns and a central bank that cannot lend to governments because of Treaty restrictions and that is reluctant to buy government debt even in the secondary markets, which the Treaty permits and which has been done by the ECB/Eurosystem through the Securities Markets Programme (SMP). As a result, there is a black hole where the sovereign lender of last resort/market maker of last resort ought to be. This is a fundamental design flaw in the Economic and Monetary Union, which is only now beginning to be addressed and corrected.

All four countries mentioned have weak governments. Italy's coalition government is currently experiencing strife between PM and MoF, plus legal uncertainty. Belgium has had a caretaker government for 14 months. Spain has announced early elections in November and France has elections next year.

The depth of the problems in Spanish banks may not be entirely apparent yet, even after 3 stress tests since 2009. Italy’s banks are very heavily exposed to the Italian sovereign, making for a vicious circle when confidence in the government is weak. Despite some recent capital raisings, they also need more capital.

Worsening financial conditions in the Euro area are also evident from the de-coupling of the swap rates and Bunds rates of the same maturity. Swap rates are based on unsecured lending and borrowing rates between AA and A-rated banks. Private credit conditions are tightening as countries considered until recently to be qualitatively distinct from the Euro area periphery are treated as periphery members by the markets. The banking sector continues to be vulnerable in the Euro Area and elsewhere in the EU and transmission of the sovereign distress to the real economy is likely to be mainly through the banking sector.

Growth in the Euro area is slowing down, driven by weaker external and domestic demand. The growth gap between the core and the periphery (including Spain and Italy) is not narrowing. Longer-term growth prospects for both Spain and Italy are also poor, partly due to demographics, but mainly because of invasive and damaging regulation of many service sectors and deeply distorted labour markets.

Without higher growth of potential output, which would require far-reaching structural reform of product and labour markets, sovereign solvency could become a material issue in both Spain and Italy.

**EFSF: not ready for prime time**

The EFSF does not (yet) have the tools to intervene in the markets to support the Spanish and Italian sovereigns. It can only make loans and give guarantees; it will use this second competency to guarantee Greek sovereign debt offered as collateral by banks wanting to borrow from the Eurosystem during the period the Greek sovereign will be in a selective ratings default. Currently, the EFSF cannot buy securities outright in either the primary or the secondary markets. Nor can it provide contingent credit lines of the kind the IMF can.

**ECB may not have the right instruments until the end of the year – national parliaments in the Euro area should reschedule their summer vacations**

All these enhanced capabilities (and more, including providing funds for recapitalising banks even in countries without Troika programmes, albeit only through the sovereign) are supposed to be added when the national ratification processes for the relevant Treaty amendments and other national approval processes have been completed. These national approval processes are not supposed to start until September, however, and may not complete until the end of the year. It is quite irresponsible, in our view, that the Euro are member states decided to send their parliaments on holiday this summer before they had enhanced and enlarged the EFSF to at least minimally effective scope and size. Crises can happen even during inconvenient periods.

Even if it had the tools, the EFSF does not have the size. Its notional lending capacity is €440bn but because of the desire to keep its debt rated AAA, its effective capacity is only around €255bn. There may be about €190bn left in the kitty. Spain's gross funding requirements this year are around €200bn and Italy's around €400bn. Even if the effective lending capacity of the EFSF is raised to €440bn (as is supposed to happen, subject to national ratifications between September and the end of the year), the EFSF will not have the ammunition to be a credible deterrent to a fear-driven market denial of market access to the Spanish and Italian sovereigns. Furthermore, to use the EFSF effectively to manage crises, it must be able to fund itself at the speed of crises. This either means pre-funding of the EFSF or access to a credit line with the ECB, guaranteed, presumably, by the Euro area member governments. Neither feature is available nor under discussion. The statement on 3 August by European Commission President Barroso on the Euro area sovereign bond markets does not create either hope or expectations that a prompt and large-scale response through the EFSF is imminent.[1]

**€440 bn effective intervention capacity for the EFSF is far too little. A sufficiently large EFSF would be rated at best AA**

The EFSF could have its capacity increased to about €1,000bn while remaining AAA. It needs, in our view, somewhere around €2,500bn to be a credible lender of last resort for solvent but illiquid sovereigns. That would make the EFSF AA at best, but so be it. Ultimately, the credit rating of an ever-larger larger EFSF should approach the weighted average sovereign credit rating of the Euro area, around AA-, and all national credit ratings would also go to that level. The political likelihood of an increase to even €1,000bn is extremely low.

[1] Statement by President Barroso on the euro area sovereign bond markets, August 3, 2011, MEMO/11/546, Brussels, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/546&format=HTML&aged=0&language=EN&guiLanguage=en.

That leaves only the ECB as lender of last resort/market maker of last resort/purchaser of securities of last resort for Spain, Italy (and in the final analysis) Belgium and France. The ECB will have to re-open the Securities SMP and buy Spanish and Italian sovereign debt outright in the secondary markets if they wish to limit the decline in secondary market prices. Even before the Spanish and Italian sovereigns have to come to the markets for large-scale funding (which would become cripplingly expensive even at current levels), declining secondary market values of Spanish and Italian would badly hit banks and insurance companies throughout the EU that hold quite a bit of this debt in mark-to-market form (in the trading book or available for sale). The ECB has not intervened through the SMP for months.

**ECB only effective rescue squad, preferably with guarantees from Euro area sovereigns, without guarantees if necessary**

As long as the ECB stays on the sidelines, a speculative, fear-driven withdrawal of market funding can feed a self-fulfilling insolvency for either or both sovereigns. It follows, in our view, that the ECB will have to come in or accept a couple of fundamentally unwarranted large sovereign defaults and the biggest banking crisis since 1931. We think the choice will be uncomfortable but easy. The ECB may be trying to extract some form of guarantee for their SMP purchases from the Euro area governments (possibly through the EFSF, as was granted for Greek sovereign debt offered as collateral at the Eurosystem for the duration of Greece's imminent (selective) ratings default), or a commitment from the EFSF to buy the ECB's SMP purchases off the ECB once the EFSF gets the power to do so. But here the capacity limits on the EFSF are a constraint. Ultimately the ECB will have to do the heavy lifting, with or without guarantees. And with sovereign rates for Spain and Italy already in the long-term unsustainable range and headed for never acceptable levels, it is key that the ECB move fast and in strength.

# Appendix A-1

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