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Implications of the eurozone crisis for the UK

An analysis of the
crisis, its potential
resolution and its
impact on the
UK market

January 2012

Executive summary

The European debt crisis intensified throughout 2011 as politicians proposed a range of solutions and markets remained uncertain as to their effectiveness. This has led to a complex situation and a spectrum of possible results for the eurozone. In this report, we analyse three potential outcomes for the crisis, and the possible effects for the UK market. We believe the European sovereign debt crisis will remain unresolved for some time, until European politicians act to establish a stable and orderly fiscal union, and have taken action to assess and mitigate relevant risks across our clients' portfolios.

What are the potential outcomes?

We believe the crisis is ultimately likely to lead either to the dissolution of European monetary union or to a confederation and fiscal union within the eurozone. We believe the latter is the more likely result, and will become ever more probable as time passes. However, rather than plotting a direct path through the crisis to achieve fiscal union, we expect the journey to be volatile and subject to numerous shocks which could derail the process.

In light of the above, we discuss the three following potential outcomes:

- Base scenario – politicians muddle through, ultimately leading to **fiscal union** (60% probability)
- Positive scenario – an orderly Greek default and a coherent flight plan to **fiscal union** (30% probability)
- Negative scenario – a disorderly Greek default leads to a **break-up of European monetary union** (10% probability)

What would fiscal union involve?

Governments would need to demonstrate solid fiscal control and secure funding to establish fiscal union. Proposals on how this could be achieved are considered in more detail further in this report.

What would happen in the markets?

The market reaction will depend on how the crisis is resolved. Regardless of the final outcome, we expect that the UK will continue to exhibit low economic growth for some time to come. We would also expect the UK government to play a lesser role in European decision making if fiscal union is achieved. In addition:

- Under the base scenario, we expect that gilt yields would remain low, risk assets would remain volatile and contagion within the global banking sector would continue to cause concern.
- Under the positive scenario, we expect that gilt yields would rise, sterling would weaken against the euro, credit spreads would normalise and liquidity would improve.
- Under the negative scenario, we would expect sterling to strengthen against a range of new European currencies. Gilt yields would probably continue to fall, credit spreads would widen and risk assets would probably underperform. The UK could enter a deflationary period and liquidity would be heavily constrained amid severe contagion in the global banking system.

The European debt crisis: what are the potential outcomes

It would be a fool's errand to predict the exact outcome of the current euro crisis. The continuing lack of a coherent strategy response from eurozone governments and the unpredictable nature of political decisions, along with a limited understanding of how the current turmoil is affecting the global economy, makes it impossible to forecast exactly how the situation will develop.

However, it is clear that a range of potential outcomes exists for the European economy and none of these outcomes is overwhelmingly positive. For clarity, we have split the economic future for Europe down a single key fault line in this paper: whether European monetary union will remain in existence. There are therefore two possible outcomes for the eurozone: the dissolution of monetary union or confederation and fiscal union. We believe the latter to be the most probable.

While there are many potential routes through the crisis, we believe there are three common paths. Our base-case scenario is an early muddle through, followed by a major event such as a disorderly Greek default or an Italian funding crisis that provokes governments to work together and speed up their policy response, pushing the eurozone towards confederation. An alternative, more positive scenario is one that would result in a streamlined path towards fiscal union, and finally a more negative path that leads to the dissolution of the eurozone.

Base scenario: politicians muddle through, ultimately leading to fiscal union (60% probability)

Our base scenario is that European governmental institutions will not permit a full disintegration of the eurozone to take place, nor will they be able to overcome competitive national self-interest to formulate a strong and coherent route forward to fiscal union in the short term. Instead, we expect eurozone governments to muddle through the crisis, with only further market crises forcing a swift move towards fiscal union. The complexity of the task ahead is already clear from recent developments, such as Britain's veto of a change to the European treaty in December, and subsequent scepticism amongst some eurozone members as to whether agreements made were best suited to their own national interests.

Positive scenario: orderly Greek default and coherent flight plan to fiscal union (30% probability)

If eurozone governments find the communal political will to work together despite their own individual national interests, the outcome could be considerably more palatable. Greece is insolvent but it could avoid a hard, involuntary default if Greece and the European banks agree over private-sector involvement. In such a scenario, Greece would remain on the path to austerity with continued support from the European Union (EU), allowing a default to be delayed until the recapitalisation of the European banking system was complete, probably in the second or third quarter of 2012. Greece would remain in the euro, accepting centrally-dictated austerity measures as a consensus emerged on the path to realising fiscal union within the eurozone. Pro-Europe governments would push through measures to speed up the fiscal realignment process, meaning fiscal union would be achieved more quickly than the markets expect. Federal bonds would ultimately be issued that would be of sufficient size and quality to genuinely be a risk-free asset class for the eurozone. The eurozone, led by Germany, would gradually heal itself.

Negative scenario: a disorderly Greek default leads to euro break-up (10% probability)

If Greece is unable to pass further austerity measures, a quarterly review by the European Commission, the International Monetary Fund (IMF) and the European Central Bank (collectively known as the Troika) could fail, leading the EU and the IMF to withhold funds. This would probably lead to a disorderly Greek default, leaving the Greek banking system looking for recapitalisation without EU support. This could lead the Greek central bank to print IOUs to recapitalise the banks, and these could become a de facto new currency. This would leave Greece at risk of leaving the euro, with significant contagion risk to other eurozone countries. The focus would then shift to other peripheral countries including Portugal and Ireland, before moving on to so-called “soft” core countries such as Spain and Italy. Even countries such as France, Austria and the Netherlands would not be immune from the contagion, and ultimately the eurozone would disintegrate as the self-interests of different national governments won through.

If this scenario were to happen, we would expect it to be relatively swift and sudden; as time passes, we believe it will become less likely to occur.

Fiscal union: what would it involve?

We believe that fiscal union is the most likely outcome of the crisis, but the path will be long and convoluted thanks to the characteristics of the current situation and the difficulties that come with negotiating and constructing a political solution.

The current European predicament is a product of fears over the solvency and liquidity of the European banking system. Investors believe that European sovereign debt bears substantial risk, and they are seeking reassurance that government bonds will neither default nor lose value as a result of other developments, such as the need to denominate existing bonds in a new currency if an issuer leaves the euro.

To reassure the markets, investors must be persuaded that the finances of European governments are on a sound foundation consisting of both solid **fiscal control** and **secure funding**. These factors are central features of any IMF programme, and politicians in the EU are making efforts to construct a solution that addresses both factors. If both are established, fiscal union will probably result below, we outline the possible elements that would constitute the two underlying pillars of fiscal union in the eurozone.

Proposals for solid fiscal control

Establishing clear fiscal control would mitigate concerns of future economic and political instability. At the moment, the more economically powerful countries in the eurozone are keen to avoid a so-called ‘transfer union’, where some governments effectively spend the tax revenues of other countries. Similar concerns could arise if the European Central Bank (ECB) purchases the debt of some nations and not others.

There are a range of potential fiscal control options. They consist of the following, in the order they are likely to be attempted:

- **Stability and growth pact:** a plan to bring deficits and outstanding debt under control is effective in theory, but a past weakness of this approach has been its dependence on individual governments monitoring each other to ensure compliance.

- **Semi-automatic sanctions:** sanctions were agreed at the summit in December but have yet to be fully ratified. Applying sanctions to non-compliant countries raises difficulties: for example, a punishment could be imposed on a government that succeeds the offending government.
- **National constitutional debt brakes or balanced budget amendments:** these are gradually being passed in most EU countries after the summit in July, and plans were tightened up in December. This might be sufficient for a country with its own currency if it has a robust independent institutional framework, but it is probable that stronger controls will be needed in a monetary union.
- **Ex-ante fiscal monitoring:** monitoring budgets through a forecasting model is often used by the IMF, and has now been proposed for European countries. Under this approach the monitoring could be performed by the European Commission or another independent body. In isolation, this approach would require governments to heed the advice of the monitors.
- **A veto on national budgets:** a veto could be applied by the European Commission or the European Court of Justice if a budget is not consistent with an agreed stability plan. This would prevent debt being issued by a government. Unfortunately, Chancellor Merkel and President Sarkozy appear to have ruled out this option for now.
- **Control of cash funding:** budget deficits relative to GDP are subject to accounting distortions, but cash levels are not. Under this approach, a central body would take ultimate control of the relevant debt management agency that issues bonds or bills. This is only likely to happen if a programme of federal bonds is implemented.

Proposals for secure funding

Fiscal control without secure funding is not sustainable. Governments that commit to fiscal discipline do not regain immediate access to market funding at a reasonable rate. In the current situation, where peripheral European sovereign debt has lost its risk-free status, market yields can remain high for long periods of time and market pressure can push fundamentally solvent countries into difficulties if yields rise too far.

Therefore, secure funding is necessary in addition to fiscal control. The funding must be so sufficient that its effectiveness will not be called into question, as has happened with the European Financial Stability Facility (EFSF)¹.

There are a range of potential options for secure funding. They consist of the following, in order of increasing efficiency, size and expected implementation:

- **Bilateral aid:** funding supplied directly between countries was behind the first Greek bailout, and other elements of substantial bailouts including the UK's loan to Ireland.
- **Aid from major institutions:** the EU, EFSF and the IMF have financed bailouts to Ireland and Portugal, and are supposed to fund the second bailout to Greece. EU aid is backed by its budget and is limited to €60bn. The EFSF, backed by partial guarantees from the unimpaired eurozone countries, is currently limited to €440bn. Creative efforts have been made to leverage it, but it has other potential commitments, and is reliant on market funding at a time when it is unclear whether Germany, and therefore other investors, would be willing to fund it. In addition, the IMF has limits on the aid it can provide.

¹ The temporary EFSF is due to be replaced with the permanent European Stability Mechanism in 2013.

- **Support from the European Central Bank:** European politicians hope that taking action over fiscal control will prompt the ECB to step up its involvement, but there are complications. The ECB could continue to lend money to help troubled sovereigns through the Securities Market Programme, but such risk placed on the ECB's balance sheet is effectively transferred to the eurozone governments that support the bank. To encourage this further would effectively create a transfer union, which stronger governments are keen to avoid. However, there are a number of ways that the ECB could provide support to troubled sovereigns: there are proposals for the EFSF to be turned into a bank to access ECB funding, or for the ECB to lend money to the IMF to increase its lending resources. Such mechanisms would keep the risk of holding risky sovereign debt away from the ECB. In theory, the ECB could lend or purchase debt by printing money², risking inflation and currency devaluation.
- **Issuance of federal bonds³:** there are a number of proposals to issue bonds jointly by eurozone (or EU) governments, for part or all of ongoing issuance needs. These would be issued in sufficient size and have enough quality to be a risk-free benchmark asset class. Chancellor Merkel and President Sarkozy appear to have ruled out this option for now.

Market impact: what would happen in each scenario?

Talking about precise market outcomes is difficult because the full effects of the crisis are likely to play out over a number of years. We have limited our analysis to the short term impact for UK investors, focusing on the next one or two years, as current uncertainty makes it difficult to construct a useful long-term scenario. We believe that some specific effects are likely under each potential outcome to the crisis. We have also limited our discussion of market impacts to investors in the UK.

1. Base scenario (politicians muddle through, ultimately leading to fiscal union)

Under this scenario, we would expect the following conditions to develop in the UK:

- **Gilt yields are likely to remain low** as the UK is viewed as a safe-haven relative to the turmoil in Europe, with long end yields likely to trade in a range of 2% to 4%. Such a position could change significantly as soon as a coherent solution develops and investors turn their attention to analysing the UK's debt problems. However, continued macroeconomic pressures are likely to be such that, even in this event, the UK would continue to report low economic growth and rates would not rise close to past levels of 5%.
- There would be **ongoing volatility in risk assets** as sentiment, rather than fundamental analysis, drives investment decisions and the market's expected outcome oscillates between the two extremes.
- **A low-growth environment would persist** in the UK as mass global deleveraging takes place.
- The UK government is likely to play a **gradually decreasing role in European decision-making**, unless a pro-Europe Labour government comes to power before full fiscal union is achieved.
- **Contagion within the global banking sector continues to cause concern but the focus remains on the weaker banks** with balance sheets that are less able to ride out the stormy conditions.

² There is a distinction between (i) the Securities Market Programme, which is risking the ECB's balance sheet to buy peripheral bonds for monetary transmission mechanism purposes; (ii) monetisation, under which the ECB would print money to fund national deficits; and (iii) Quantitative Easing, under which the ECB would print money to prevent a fall in the supply of money and credit that could lead to deflation. The ECB's mandate covers (i) and (iii), but not (ii).

³ Federal bonds are also referred to as eurobonds, or as stability bonds by the European Commission.

2. Positive scenario (orderly Greek default and coherent flight plan to fiscal union)

Under this scenario, we would expect the following conditions to develop in the UK:

- **Gilt yields may rise** as debt problems are gradually resolved in Europe and the UK's safe-haven status comes under scrutiny.
- Sterling may weaken slightly against the euro as a result of positive sentiment relating to the eurozone, but major currency movements are unlikely.
- Significant debt would remain in the system, and would need to be reduced through a deleveraging process. This would lead to a **low-growth environment in the UK, but a deflationary period could be avoided** depending on the depth of any recession in the eurozone.
- **Credit spreads would probably normalise** and there may be a **slight increase in demand for risk assets** in the form of a relief rally.
- **Liquidity would probably improve** as fear in the system abates and central banks work together to keep markets liquid.
- Fiscal union in Europe would probably **sideline the UK in major European decision making about the future of the euro economic zone**. However, it is worth stressing that most institutions in Europe are based on the European Union rather than the European monetary union, so any such process would be gradual and occur over the longer term.

3. Negative scenario (a disorderly Greek default leads to euro break-up)

Under this scenario, we would expect the following conditions to develop in the UK:

- The emergence of new eurozone currencies would cause **sterling to strengthen in general, though possibly not against a new Deutsche Mark**. Our studies have shown that the devaluation of affected currencies is likely to overshoot by 2.5 times in this situation before rebounding to a neutral level, so currency volatility would probably be very high.
- Money would flow into the UK which would be viewed as a safe-haven during the disintegration of European monetary union. As a result, **gilt yields would probably continue to fall**.
- A major recession or even depression would likely develop in Europe. The UK would also be dragged under into **low growth and a potentially deflationary environment** for a number of years.
- **Credit spreads may widen and risk assets would be likely to underperform** as investors fled to defensive alternatives. All short-term fundamentals would probably be swamped by fear and contagion. After the initial shock, there would likely be a bifurcation of credit markets based on the ability of individual companies to service their non-European debt.
- **Liquidity would be heavily constrained** as markets are paralysed by fear.
- There would be **severe contagion within the global banking system** with systemic downgrades and the nationalisation of a number of vulnerable banks, both in Europe and the UK.
- The impact on European swap contracts held in the UK is unclear but is likely to be extremely complex with multiple currency and valuation issues.

Conclusion

We expect fiscal union to be achieved as eurozone governments act together to work through the crisis. Such a union would consist of centralised fiscal control and common bond issuance. The complexity of the task and competing national interests leads us to believe it is unlikely to occur in the short term, but we expect that a further market crisis would force a swift move towards such union being established.

There remains a material risk that our negative scenario could come to pass: a disorderly Greek default could lead to a complete break-up of European monetary union. This would have a substantial impact on investors as several new currencies emerged and were substantially devalued, affecting credit and other holdings. However, we would emphasise our expectation that European politicians will ultimately act to establish a stable and orderly fiscal union.

Notes

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