EMU: Fixing it is far cheaper than breaking it

Core countries’ exposure exceeds €2tn

ECB President Draghi states that the euro is irreversible and that there will be no going back to the Lira, or the Drachma, or any other precursor currency. But what if Greece were to leave the EMU and trigger an exodus of others? In this report, we assess the balance sheet exposure of ‘core’ countries to the periphery. Our results show that the total official and banking sector exposure would be €2.2tn, or 36% of core country GDP. While the costs of sustaining the EMU in its current form are large and growing, the good news is that this is reversible. The challenge is that this depends on Eurozone leaders stepping up progress on recent policy initiatives.

Fig 1 Core countries’ official and banking exposure to the Eurozone periphery*

![Graph showing official and banking exposure of core countries to the Eurozone periphery](image)

Source: European Commission, IMF, ECB, EFSF, BIS, National Central Banks, ING
* In case of a concerted euro exit of the mentioned peripheral economies
** Includes exposure of state-backed bad banks FMS Wertmanagement and Erste Abwicklungsanstalt
Note: banking sector exposures are as of March 2012

A crucial month for the EMU, and for Greece

We are on the brink of another crucial month for the survival of the Eurozone. It takes in not only the ruling of the German constitutional court on 12 September, a potential request from Spain for a bailout, and a delicately poised general election in the Netherlands, but also the Troika’s review of the Greek bailout programme.

It is far from sure whether European leaders will be willing to continue to support Greece if it turns out that the country is unwilling to implement the necessary reforms. Some politicians have already started to increase the pressure on the Greek government. Euro group Chairman, Jean-Claude Juncker, said that a Greek exit would be manageable, if not desirable. Former ECB Chief Economist, Otmar Issing, declared on CNBC; “The idea that we should have a policy that no country ever should leave is something which is an invitation to blackmail”. Deputy parliamentary leader of Merkel’s CDU party, Michael Fuchs, even added that Germany may veto Greece’s next aid package should Athens not meet all its targets. In the absence of any debt forgiveness, this might force Greece into
default. While theoretically this does not need to imply a Greek exit, we think it would be unacceptable for the other Eurozone members for Greece to remain in the EMU under these circumstances. As we explained in our note dated 25 May, *A Greek cliff-hanger – What would happen if Greece defaults*, a default is ultimately likely to end in exit.

### Potential losses from a Greek exit

What would be the potential balance sheet loss to other Eurozone countries in case of a Greek exit? The total official sector exposure of Eurozone countries to Greece currently amounts to €293bn, or about 3% of Eurozone GDP. This consists of:

- The bilateral loans from the first bailout package and the money already disbursed from the second package: €127bn.
- The net liabilities of the Bank of Greece to the Eurosystem resulting from Target2 debts and the disproportionate allocation of euro banknotes: €127bn.
- The estimated purchase price of the Greek government bonds still owned by the ECB: €35bn.
- The indirect exposure through the stakes in the IMF, which has lent Greece €21.7bn thus far: €5bn.

The German share of this is €83bn, or 3.2% of GDP, which is slightly more than that of the other ‘core’ countries (see Table 1 in the appendix). This is mainly because the ECB capital keys – which we use to calculate the exposure related to Greece’s intra-Eurosystem net liabilities – are not just based on the relative size of GDP, but also on relative shares in total population.

Banking sector exposures to Greece have fallen sharply in the run up to and after the Greek debt exchange. But in some countries, notably France, the banking sector exposure to Greece is still significant, partly due to local banking operations. Note that the German state-backed bad banks, FMS Wertmanagement and Erste Abwicklungsanstal, still hold sizeable claims against Greece.

If Greece were to fully default on all of these external liabilities in case of an exit, the direct balance sheet losses for the ‘core’ Eurozone countries would be significant, but probably manageable. This would still hold if we were to include losses on the exposures of other financials and corporates, as well as the cost of additional funding that might have to be provided by the IMF and/or the Eurozone to ease the economic and political pain of Greece’s exit.

However, on top of the balance sheet effects, we also have to take into account the income or ‘flow’ effects of a Greek exit. In our report dated December 2011, *EMU Break-up: Pay now, pay later*, we assessed the economic impact of a Greek euro exit. The estimated GDP growth cost (measured as the difference from the base case) varied from c.1.2% of GDP in the first year after an exit for the average core country to c.2% for the average peripheral economy (ex Greece). But much would depend on the ability to contain the contagion arising from the fear of other countries following Greece to the exit.

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1 In the remainder of this note, we focus on the exposure of six ‘core’ countries for which we have data on banking sector exposures: Germany, France, the Netherlands, Belgium, Austria and Finland.
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The main risk would arguably come from bank runs

Containing the contagion

Containing the contagion from a Greek exit would likely prove very challenging. The main risk would arguably come from bank runs in other peripheral countries. If the euro were to prove reversible, depositors in Portugal, Spain and other peripheral countries would surely ask themselves the question: are we next?

One way of tackling this would be to establish overnight a euro-wide deposit guarantee scheme that would guarantee deposits in euro (and hence protect deposits against redenomination risk). But we strongly doubt whether such a drastic decision would be politically feasible in the core countries, even in an emergency situation. In other words, there is a distinct possibility that a Greek exit might culminate in a wider exit of other countries triggered by bank runs. Indeed, after Greece, other peripheral countries might be forced to follow suit.
Losses from a wider exit of peripheral countries would dwarf those of a ‘Grexit’

Potential losses from a wider exit of peripheral countries

The potential balance sheet losses to the core Eurozone countries of a wider exit of peripheral countries would clearly dwarf those in case of a Greek only exit. Our analysis of the core countries’ exposure in case of an exit of Greece, Portugal, Ireland, Spain and Italy yields the following results:

- If we assume that all of the exiting countries were to default on their guarantees to the EFSF and would no longer be liable for any future Eurosystem losses, the total official exposure of the ‘core’ countries would be €1.3tn (see Table 2 of the Appendix). This is equivalent to 21.4% of the core countries’ combined GDP.
- The biggest official exposure lies in the Eurosystem. The ECB holds an additional €175bn of Irish, Portuguese, Spanish and Italian bonds bought over the past two years. In addition, it has claims on the other four countries through the Target2 system of around €832bn.
- By country, the biggest official exposures are to Spain with Italy not far behind. Although the ECB has bought more Italian than Spanish bonds, the Target2 debts of the bank of Spain are currently more than €100bn higher than those of the Bank of Italy. If we were to include the €100bn committed to the bailout of the Spanish banking system, this gap would become wider.
- Germany’s sovereign and banks would potentially be on the hook for an aggregate €921bn or 35.9% of GDP, of which the official sector accounts for €570bn, or 22.2% of GDP.
- France is most exposed to direct balance sheet losses in case of a GIPSI exit, with a total exposure of 41.6% of GDP, or €829bn, with the total almost evenly split between official and banking sector exposure.

Source: European Commission, IMF, ECB, EFSF, BIS, ING

* Includes exposure of state-backed bad banks, FMS Wertmanagement and Erste Abwicklungsanstalt

Source: European Commission, IMF, ECB, EFSF, BIS, ING

A recent article in ‘The Economist’ newspaper (The Merkel Memorandum, 11 August 2012) focused on the exposure of the German government. Here we also examine the exposure of the other core countries and include an analysis of banking sector exposures. We are also analysing the private non-banking exposure to periphery, which we will shed more light on in subsequent country-specific notes.

Based on figures as of March 2012
For the Netherlands, exposure is similar to Germany

- For the Netherlands, the official exposure is 21% of GDP, or €121bn, while bank exposure is second to France, at 15.6% GDP.
- Finland has the ‘smallest’ total official and banking sector exposure of 20.7% of GDP.

Please note that in our calculations, we have only included actual disbursements. If we were to include the remaining commitments, including the €100bn for the bailout of Spanish banks and the pending disbursements to Greece, Portugal and Ireland, this would raise core countries’ exposure by around 3ppt of GDP.

The costs of survival might stop rising

The debate about the EMU in the core countries is being fuelled by the perception that the costs of keeping it intact are rising. Two factors are behind this:

1. The increasing distress of the peripheral economies, where the precedent of the collapse in Greece is now plaguing Spain.
2. The ongoing capital flight as private investors and depositors are in danger of creating a self-fulfilling loss of confidence in the current strategy. High bond yield spreads and growing Target 2 central bank liabilities have been potent symptoms of this. Figure 8 shows that the private capital outflow in the first half of this year was a significant €398bn (non-annualised) or the equivalent of 25% of the periphery’s GDP.

Draghi’s promises of action to support the periphery have helped to soothe nerves in recent weeks. Nevertheless, there are severe doubts about their delivery, given that they are contingent on responses from the politicians.

Fig 8 Balance of payments flows periphery*: private capital takes flight

Nevertheless, while the upward trend in the costs of survival has been disturbing, it is not inevitable that it will continue. If policy moves into a more credible road to survival, then the evidently rising cost of sustaining EMU could start to stabilise, and even fall. The most immediate way in which this could happen is a reversal of the capital flight from the periphery. This could be triggered by quantitative easing or concrete steps towards banking union or common bonds. The last could prompt a huge “survival trade” into peripheral government debt.
Box 1: The road to survival: two steps forward, one step back

Despite talk of an EMU exit for Greece and perhaps others, there still seems to be a consensus amongst European leaders to prevent such an outcome. As yet, they have failed to deliver a strategy that will do so. In our report dated 5 June 2012, Roads to survival – How EMU break-up could be avoided, we argued that the survival of the Eurozone ultimately requires a combination of reform, reflation and redistribution. Sadly, for now, the path being pursued most resembles the ‘Austeria’ scenario that we described in the report, as continued austerity and credit rationing continues to push unemployment in peripheral countries to democratically unsustainable levels. The core countries remain reluctant to bear the cost of securing the EMU. In the process, the danger is that delaying necessary measures only tends to increase the cost of a rescue further.

The European Commission, the ECB and politicians in the core countries are continuing to put the emphasis on reform. This is certainly needed. And peripheral countries have already implemented, in various degrees, structural reform. But without reflation and some form of redistribution, reform is unlikely to run very far, as it might have a deflationary impact in the short-term (with a “J-curve”-like effect in growth).

As for redistribution, steps towards a banking union were agreed at the European summit in June. The first steps are the involvement of the ECB in supervision on a European level and the possibility of using the ESM as a bank recapitalisation/resolution fund. That might already reduce the burden on the peripheral countries. However, a European deposit guarantee scheme, a necessary condition to stop the capital flight and balkanization of financial markets, will be harder to push through. The matter might be taken up again at the December summit.

As for fiscal redistribution, a transfer union still seems to be a hard sell in core countries. Although a Greek official sector involvement (which we believe is likely), would de facto be a transfer, we do not expect a comprehensive system of more permanent redistribution between stronger and weaker member states to be set up in the foreseeable future.

That said, it looks likely that some sort of debt mutualisation will be introduced in the coming years. The idea of a European Ministry of Finance, able to veto the budgets of the individual member states, might gain ground amongst peripheral countries, if it would open the door for a German acceptance a common bond. Indeed, as the countries in trouble are now already being scrutinised closely by the Troika or the Commission, it would not make that much difference. France is probably the pivotal player in this regard, as it has put much emphasis on its sovereignty in the past. The good news is that in Germany the Social Democratic Party, the biggest opposition party, has now declared itself in favour of a common bond in the run-up to the general elections in 2013.

As for reflation, budget deficit targets have been loosened marginally for peripheral countries, but the ECB remains insistent on aggressive fiscal tightening as pre-condition for its help. While monetary policy is not able to neutralise the effects of tight fiscal policy, it could to some extent ease the burden. We believe that if sufficient safeguards are in place to limit moral hazard (eg, we think that Spain is going to ask officially EFSF intervention in September, signing a memorandum to abide to a long-term budget consolidation strategy), the ECB will fulfil its part of the deal (even against the will of the Bundesbank). That might be under the form of more aggressive QE, eventually also granting a banking license to the ESM (this could happen after the December summit).

In sum, in terms of the survival of the EMU, we judge the policy outlook as being a case of two steps forward and one step back. That implies that a return to healthy GDP growth for the Eurozone will remain elusive.

Peter Vanden Houte
Moreover, beneath the headlines, there are signs of fundamental improvements. In particular, external deficits of the periphery, led crucially by Spain, have been falling for some time (see Figure 9). This is an important driver of the accumulated central bank liabilities measured by Target2.

However, as we pointed out in our Roads to Survival report, the EMU’s sustainability ultimately depends not just on external balances, but internal balances as well. Now the problem is that the falls in the periphery’s current account deficits are in part the result of weak domestic demand brought on by fiscal austerity and credit scarcity. As a result, the current account improvement has been accompanied by rising unemployment (see Figure 10). This has been politically toxic as well as economically damaging. It has undermined the periphery’s governments and made their relations with the core fractious.

Thus, the financial markets’ welcome to the recent promises of supportive action has to be heavily qualified. Lower funding costs and stemming the capital flight are necessary but far from sufficient. The Austerians still hold sway over the Krugmanians, barring the way to fiscal reflation and making it harder to foresee a convincing recovery. Indeed, we are left with unappetising thought that further setbacks, whether in the shape of a deeper plunge into recession and/or fresh financial market trauma, might be needed for the Austerians to retreat. Recall that even Germany engaged in the emergency fiscal reflation that followed the collapse of Lehman Brothers in 2008. In the meantime, the road to survival looks set to remain tortuous and fragile.

Conclusion

Core country politicians are talking openly of a Greek exit or a broader breakup of the EMU. Given the significant balance sheet exposure of the core countries to the periphery, let alone the guaranteed recession that would follow, we are left wondering why. Here are some potential explanations:

1) Pressurising the periphery: the threat of EMU departure may be designed to put pressure on Greece and the other peripheral countries to deliver on their side of the Austerian bargain of austerity and reform.

2) Pleasing the voters: talk of exits may play well with core country voters suffering from ‘bail-out fatigue’.

3) Recognising reality: there is a growing feeling that the Greek government will not be able to deliver.
4) “It’s manageable”: since private sector investors in Greece have already taken big losses and firewalls are being strengthened for the rest of the periphery, it is felt that at least a ‘Grexit’ would not be as damaging as previously thought.

5) “It will be cheaper”: there is a view that since the costs of fixing the EMU are rising in an unsustainable way, ‘Grexit’ might prove to be cheaper in the long-term.

As regards the first three points, we remain reticent about being drawn into the political debate. However, we would merely reflect on the first point that if indeed the intent has been to put pressure on the periphery, then at least in Greece, this has not gone well. As for the second, this is testimony to a collective inability of pro-euro politicians to sell the benefits of the EMU, let alone explain the horrendous costs of breakup. On the third point, while everyone would accept that Greece needs to reform its public sector and tax collection operations, there is a real question as to whether the scale of fiscal austerity that Greece is being invited to execute is feasible.

The final two points on the list bring us back to the economic thrust of the ‘exit strategy’. On the manageability of Grexit, it is true that private sector creditors have already suffered much the pain on their Greek exposure. But, as our figures show, this still leaves huge official sector exposure. In other words, taxpayers are on the hook, especially in the core countries. The fact that the exposure is now more concentrated in official hands may make it more manageable, if only in the sense that the destination of the bills is clearer, but this will not make the loss any less painful. Moreover, containing the contagion from a Greek exit would likely prove very challenging.

This leaves us with the question of cost. As we have argued in this report, even if we set aside the possibility of a contagious and chaotic recession, EMU exits would crystallise enormous losses on the core countries’ exposure. For the official sector alone, the gross exposures of the core to the periphery amount to €1.3tn, equivalent to 21.4% of their combined GDP. Although the net loss would depend on the extent of capital and currency depreciation, the scale is sobering.

It is true that in the meantime the cost of fixing the EMU has been rising. Successive bailouts have failed to end the crisis. With the core governments reluctant to pledge more resources to support the periphery, the ECB has reluctantly played the role of fire brigade with a series of unconventional measures.

So the Paradox of Merkelism, whereby the attempt to minimise the cost of sustaining the EMU has served to increase it, lives on. In Roads to Survival, we argued that survival could be built on three dimensions: reform, redistribution and reflation. Some steps are being made towards reform and redistribution. Moves to banking union and common bonds could even start to reverse the capital flight that has been increasing the core governments’ exposures. But for now, it is doubtful whether the steps towards reform and redistribution will be enough to compensate for the continuing backward steps on fiscal reflation.
Appendix – Exposure Tables

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1. Euro area countries’ exposure to Greece – Greek exit

<table>
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<th>EUR bn</th>
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Note: totals in Italics exclude bank claims

Source: ING

2. Core countries’ exposure to periphery – wider exit

Core countries’ official and banking exposure to periphery – wider exit (EUR bn)

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* as of 30th April 2012

Source: ING

In this scenario, we assume that five countries leave the EMU: Greece, Portugal, Ireland, Spain and Italy. We assume that these exiting countries will default on their guarantees to the EFSF, and that they do not share in any losses on the (remaining) exposure of the Eurosystem.
3. Euro area countries’ exposure to Greece – wider exit

Exposure of eurozone governments and banks to Greece - wider exit

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Note: Totals in italics exclude bank claims

Source: ING

4. Euro area countries’ exposure to Ireland – wider exit

Exposure of eurozone governments and banks to Ireland - wider exit

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Note: Totals in italics exclude bank claims

Source: ING
5. Euro area countries’ exposure to Portugal – wider exit

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Note: totals in Italic exclude bank claims.

Source: ING

6. Euro area countries’ exposure to Spain – wider exit

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Note: totals in Italic exclude bank claims.

Source: ING
7. Euro area countries’ exposure to Italy – wider exit

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Source: ING
### Research analyst contacts

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