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The euro zone: trouble in the periphery

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In Brief

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Patrick Zweifel, Chief Economist

- The debts accumulated by countries in the euro zone's periphery remain a concern
- In particular, Portugal and Italy would have limited fiscal room for manoeuvre in the event of recession
- Currently, neither country features in the Pictet-Global Bonds Fundamental portfolio

Greece is not the only weak link in the euro zone. There are some other countries in the region's periphery that could be hamstrung by their high public debts in the event of recession. The European Central Bank's quantitative easing programme may have given these economies some breathing space but the euro zone's future can only be secured by deepening ties among its member states.

Imagine waking up tomorrow to discover that Greece's precipitous slide into a debt vortex had been nothing but a bad dream. Its shattered economy, the month-long shuttering of its banks, its possible exit from the euro zone – all part of the same disturbing nightmare.

How would the euro zone look on such a morning?

In reasonable condition, perhaps. But hardly a picture of perfect health.

True, the region's households and businesses are shedding debt. Household debt as a proportion of GDP has shrunk by more than 3 percentage points since 2009 to about 60 per cent, considerably below that of the US, which is running at 76 per cent. Corporate balance sheets are healthier too. Excluding the financial sector, euro zone company borrowing amounts to 100 per cent of GDP, a 7.5 percentage point decline from a peak hit six years ago.

Yet, as any student of credit crises knows, cutting private debt is just the first step countries must take to place their finances on a more stable footing. And judging from the progress made so far, there are a fair number of euro zone nations besides Greece that remain stuck in the danger zone.

That's because debt reduction – or deleveraging – is a complex and drawn-out process, part of a long credit cycle whose phases overlap and unfold over many years. The cycle typically begins with the build-up of private debt which, left unchecked, morphs into a credit bubble. When this bursts and recession ensues, private debts fall and public debts rise, either because governments assume private liabilities or because slower economic growth reduces tax revenue. Then begins the most difficult task of all: bringing down public borrowing.

Knowing how far a country has progressed along the credit cycle is of critical importance to policymakers and investors. Not only does such information show whether debts are becoming manageable, it also lays bare a nation's

defences against an unforeseen shock. Viewing the single currency region through this lens, a disturbing picture emerges. In their present state, and without region-wide reform, Italy and Portugal might not be able to survive another Lehman-like crisis. And though Spain is in a better position, it cannot take the improvement in its debt dynamics for granted.

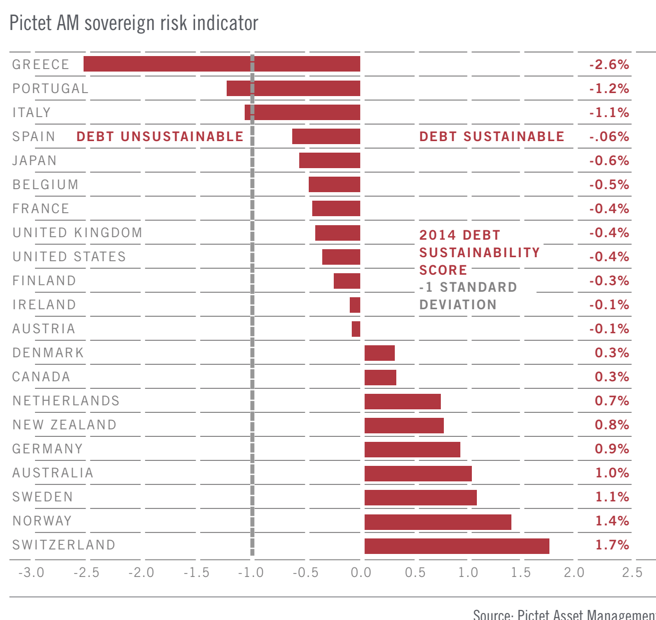
These countries are at the top of our global sovereign vulnerability index because they each have at least one glaring weak spot on their balance sheets.

The debt risk framework we have devised ranks euro zone nations along three dimensions. The first is the affordability of a country's obligations. This we determine by looking at measures such as the debt-to-GDP ratio and the level of interest payments as a proportion of fiscal revenue. The second dimension is what we describe as the *financeability* of debt, or the extent to which a nation's public debts can – in extremis – be financed by the domestic private sector. Here, the level of private savings and government revenues as a percentage of GDP serve as reliable indicators. The third dimension is debt reversibility – in other words, the ease with which a country can reduce debt through economic growth. This can be captured by metrics such as the gap between a country's nominal growth rate and its cost of capital. The greater the gap, the lower the risk.

The nations at the riskier end of the spectrum (see Fig. 1) have the same troubling weaknesses: the crowding out of private investment by public borrowing and high debt servicing costs.

FIG 1 – EURO ZONE'S PERIPHERY VULNERABLE TO DEBT OVERLOAD

Pictet AM sovereign risk indicator

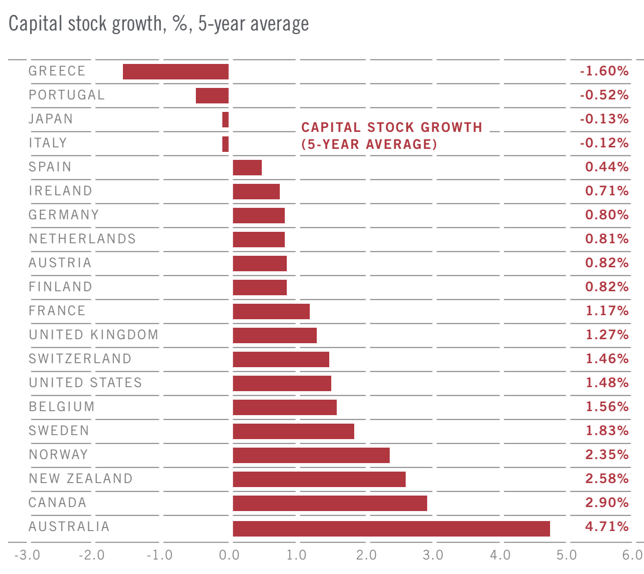


Source: Pictet Asset Management

With public borrowing having outweighed private investment in Portugal, Spain and Italy in recent years, these countries' stock of capital has either remained at a standstill or contracted since 2009 (see Fig.2) Equally concerning for these nation's growth prospects is the weight of debt resting on the shoulders of younger age groups. In Italy, for instance, if the debt servicing cost is spread among those under 15 years of age, it would amount to almost EUR9,000 per person, almost double that of countries such as Germany, France and Greece.

FIG. 2 – CAPITAL STOCK CONTRACTING IN COUNTRIES WITH HIGHEST PUBLIC DEBT

Capital stock growth, %, 5-year average



Source: Pictet Asset Management

That's not to say Rome, Lisbon - or Madrid for that matter - will find it impossible to bring their debts under control. By our calculations, Italy would need to deliver nominal economic growth of some 1.4 per cent per year over the next five years to stabilise its debt to GDP ratio at 136 per cent. For Portugal and Spain to achieve a similar feat, their economies would need to grow at an annual 1.3 per cent and 3.4 per cent respectively. Over a five-year horizon, this looks realistic enough although it would require more austerity and progress on structural reform first.

The problem with these forecasts, however, is that they assume the next five years will be devoid of financial shocks. No-one can guarantee that. On average, recessions take place every six years in Europe.

Should an economic slump occur, none of the euro zone's weak links will have sufficient fiscal ammunition. Their debt burdens are simply too high for them to increase public expenditure. Of course, with the European Central Bank having conquered its aversion to quantitative easing, fiscal wiggle room could in theory be limitless. But for the single currency region to establish a strong defence against future financial crises, it cannot rely on the ECB alone. The only credible solution lies in deepening the fiscal ties between the region's member states. There are various ways to achieve that. Bundling countries' obligations into region-wide euro bonds is one option, as is allowing the

transfer of public funds from nations running surpluses to those with deficits. Another is the setting up of a euro zone-wide employment insurance scheme. Progress on any of these fronts would be welcome – something good for investors to wake up to.

Patrick Zweifel, Chief Economist

Patrick Zweifel joined Pictet in 1997. He is Chief Economist at Pictet Asset Management, having assumed the position in 2009. Before that, he was head of the "Macro Research Team" at Pictet Private Wealth Management, where he was responsible for emerging markets and Japan, and for the development of quantitative models on major asset classes. Before joining Pictet he was a research assistant in econometrics and monetary theory and worked on international research projects for the World Bank and the European Union. He holds a PhD in Econometrics from the University of Lausanne.

SOVEREIGN RISK INDICATOR AND PICTET-GLOBAL BONDS FUNDAMENTAL

Mickael Benhaim, Co-Head of Global & Regional Bonds Global Bonds

Pictet AM's proprietary sovereign risk indicator is used to help in the construction of our actively-managed Pictet-Global Bonds Fundamental fund, which invests in debt issued by governments that we believe have sufficient financial capacity and willingness to honour their debt obligations.

At present, neither Portuguese nor Italian government bonds feature in the portfolio. Their exclusion partly reflects the vulnerabilities uncovered by our sovereign risk model. But this does not mean they cannot be included in future. Ireland's government bonds, for instance, did not feature in the portfolio in the first three years of its existence (January 2012-December 2014) because the country scored poorly in terms of debt sustainability. Thanks to the reforms put in place by the Irish government in recent years, however, the country's credit profile has improved considerably, which gave us the confidence to invest in its sovereign debt. Irish government bonds were included in the portfolio for the first time in January 2015, and make up 1 per cent of total assets under management.

Mickael Benhaim, Co-Head of Global & Regional Bonds Global Bonds team

Mickael Benhaim joined Pictet Asset Management's Fixed Income team in 2006 and is Co-Head of Global & Regional Bonds. Before joining Pictet, he was Head of Euro Aggregate Fixed Income for Axa Investment Managers where he worked for five years. Mickael has more than 20 years' professional experience that includes working at the Dresdner Group and BNP Paribas Group. He holds a MSc in Mathematics and a post-graduate degree in stochastic models from the University of Paris Jussieu and Paris Panthéon-Sorbonne.

Contact details

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