# The debt crisis

## Next hurdles for the Eurozone

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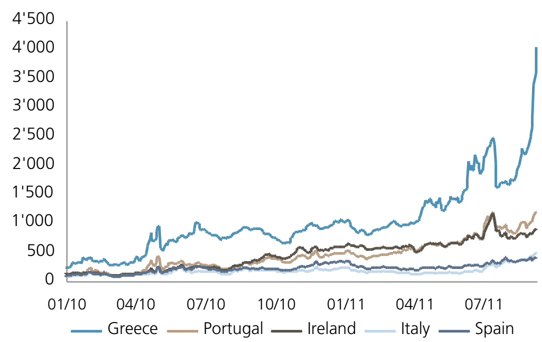
- A Greek default is imminent within the next six months and we think the Eurozone is currently unable to deliver a solid response to mitigate contagion to other countries and into its banking sectors.
- We explain our baseline views for all major Eurozone countries facing funding cost pressure and assess the forms of banking sector support that will be required to prevent a systemic crisis.
- We assess near-term decision points and their possible outcomes and conclude that the sovereign debt crisis will turn much worse before any sustainable recovery may be expected.


*Please also refer to our previous reports in the series "The debt crisis."*

**Fig 1: CDS risk premiums rise strongly**
in basis points




Source: Bloomberg, UBS WMR, as of 14 September 2011.

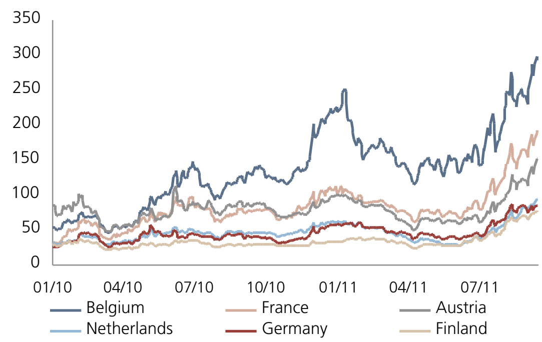
### Summary of our views

- Greece will most likely default within the next six months, its bonds will decline further in value and the country will stay within the Eurozone following a default. There will be a multi-stage default, and we do not expect a fast restructuring agreement.
- Portugal and Ireland are unlikely to default over the next two years, but they will remain dependent on support loans from the EU and the IMF for longer. Ireland is more likely to achieve fiscal consolidation than Portugal, which may default in the longer term.
- Both Italy and Spain are highly unlikely to default over the next five years and their bonds appear relatively cheap. However, we think they will become even cheaper and advise against buying now. We think massive further ECB bond buying will be required to contain Italian and Spanish yields following a Greek default, as EFSF support is not feasible to cover the funding needs of Italy.
- Belgium and France will be strongly impacted by contagion following a Greek default and costs to rescue banks will weigh on sovereign credit quality. ECB bond buying may be required to prevent excessive government bond yields.
- European banks will require support in various forms, including capital injections, funding guarantees and additional liquidity facilities. All this can be provided, but hesitant political decisions and a generally reactive stance will lead to massive pressure on bank bonds and stocks before any sizeable measures finally become available.

- Given strong political disagreement on the appropriate measures to stabilize the Eurozone, we expect no far-reaching decisions to be taken following a Greek default. We view the introduction of Eurobonds as unlikely in the near to medium term, despite such instruments being suggested by weaker member countries. We think European leaders will neither be in a position to agree on more fiscal integration in the near term, nor will they allow a break-up of the monetary union. Instead, we will see a continued piecemeal approach, which will not please financial markets.
- Possible financial support from emerging markets like China and Russia will not rescue ailing governments, but we expect these countries to use the European crisis to benefit by acquiring real assets at depressed valuations.

Please review the sections below for more detailed arguments supporting our views.

**Fig 2: CDS risk premiums for core Europe**
in basis points




Source: Bloomberg, UBS WMR, as of 14 September 2011.

### Upcoming events in the Eurozone

The Eurozone countries are currently about to revise the European Financial Stability Facility (EFSF). All parliaments of the 17 member countries states will have to ratify the necessary amendments of the contract establishing the EFSF. France was the first country approving it on the 7th and 8th of September, while the other countries are following in the course of September and October. Since Slovakia plans its parliamentary debate only for December, the revision may likely become effective only by the beginning of 2012. A revised EFSF should have a lending capacity of EUR 440bn and expanded flexibility for interventions in cases of instability, by buying bonds in the secondary market and supporting the banking sector directly with capital.

In our base case we are assuming the approval process will be successful, even if some sabre rattling motivated by domestic politics will occur. The following decisions carry potential risk:

- The vote in the German Bundestag scheduled for 29 September with the preceding debate: a rising number of members of parliament belonging to the ruling coalition is currently expressing criticism. As the opposition SPD is supporting the EFSF revision, the majority is not threatened. Some critics may probably become supportive in the last minute to prevent a political crisis from triggering early elections, probably resulting in a great coalition including CDU/CSU and SPD.
- Votes in countries with low Greek exposure, primarily Finland: contrary to Germany and France, where special interest groups representing the creditors and the export-oriented companies exist, Finland is much less concerned by Greece's fate. Despite the broad-based governing coalition supporting Europe, Finland might insist on getting additional collateral for its loans. The arrangement regarding collateral should be sealed by the second half of September. Besides Finland, Austria, Estonia and the Netherlands have also announced their interest in such a solution. The parliamentary debates in those countries have not been scheduled for now but are likely to take place right after the collateral deal, which will likely be concluded to the satisfaction of all countries.

**Important events**

| Date | Issue |
|---|---|
| 07.09.2011 | German Constitutional Court rejects complaints against German support for 1st Greek bailout package and EFSF |
| 07./08.09.2011 | French parliament approves EFSF revision and 2nd Greek bailout package (first country) |
| 07./14.09.2011 | Italian parliament approves austerity measures |
| Mid Sept 2011 | Likely start of the parliamentary debate on EFSF revision in Spain |
| 14.09.2011 | Likely start of the parliamentary debate on EFSF revision in the Netherlands |
| 15.09.2011 | Spanish vote on 2012 budget |
| 16./17.09.2011 | Ecofin meeting in Wroclaw, details on the provision regarding collateral deals with Greece likely to be published |
| Mid Sept 2011 | Likely start of the parliamentary debate on EFSF revision in Finland, Italy, Spain |
| 19.-22.09.2011 | Parliamentary debate on EFSF revision in Germany (excl. vote) |
| 21.09.2011 | Possible start of the parliamentary debate on EFSF revision in Austria |
| 29.09.2011 | Re-scheduled parliamentary vote on EFSF revision in Germany |
| Sep 2011 | IMF review of Greek, Portuguese and Irish austerity program |
| Mid Oct 2011 | Italian parliament deadline to vote for the new austerity measures |
| 01.11.2011 | ECB President J.-C. Trichet to be succeeded by M. Draghi |
| 20.11.2011 | Spanish elections (snap) |
| Dec 2011 | Parliamentary debate on EFSF revision in Slovakia (last country) |
| Dec 2011 | IMF review of Greek, Portuguese and Irish austerity program |
| 01.01.2012 | Likely date for the revised EFSF to become effective |
| 22.04.2012 | French presidential elections |
| 10.06.2012 | French parliamentary elections |
| Year 2013 | Greek parliametary elections |
| Apr 2013 | Italian parliametary elections |
| May 2013 | Italian presidential elections |
| 01.07.2013 | ESM to become effective |

Source: UBS WMR

- Other major political events include the French elections (presidential in April, parliamentary in June 2012), where we assume that no change in France's stance toward Europe is to be expected. The Italian parliamentary elections are scheduled for spring 2013. The latter could be of relevance for Italy's attitude regarding the further implementation of the austerity measures.

## Greece – timing of the default

We have repeatedly emphasized that Greece needs a large debt reduction (see 18 July: "The debt crisis: Timing of a Greek default and contagion effects" and 26 May: "The debt crisis: Greece: Rhetoric aside, a default is a default"). Despite all EU/IMF efforts to support Greece, we maintain the view that a full default affecting all bondholders is most likely to occur by March 2012 at the latest. By then, Greece would face the third review of its enhanced adjustment program that was agreed on in June, when Greece proved unable to stick to the targets of its initial adjustment program. The new plan rests on three pillars, and we think Greece will fail on all of them: 1) further fiscal adjustments will not yield the intended fiscal improvements as the economy is being sent much deeper into recession than initially estimated; 2) privatization plans aim at raising up to EUR 50bn by selling stakes in public companies and real estate, which unsurprisingly does not work at all in a crisis environment; and 3) the private sector involvement (PSI) initiative that targeted a 90% participation rate of European banks in a roll-over of Greek debt only achieved some 70% acceptance, which is by far insufficient to ease the funding cost pressure on Greece.

**Previous WMR publications on Greece**

- 18 July: "The debt crisis: Timing of a Greek default and contagion effects"
- 26 May: "The debt crisis: Greece: Rhetoric aside, a default is a default"
- 17 June: "The debt crisis: Greece update"
- 25 January: "The debt crisis: Sovereign debt in the age of austerity"

Source: UBS WMR

**How likely is a near-term default?**

We think Greece is in a situation where a default can happen at any time. This event can be triggered either by the Greek government or by the official creditors. We think the Greek government is extremely unlikely to choose to default as long as there is any hope left that it may receive more external loans to cover its debt obligations. In such a desperate situation, we believe the government would commit to almost any creative measures to facilitate further support. A default may, in our view, only be triggered by Greece itself if the government falls as a result of public unrest.

As a consequence, we focus on decision points of external creditors, which are essentially the quarterly reviews of the adjustment program, to identify a possible timing of a default event. The current program review appears to show that Greece is again clearly behind the targets of its overambitious plan. The Greek government recently introduced a one-off real estate tax, which we think may be sufficient to provide the troika (ECB, EU, IMF) with something tangible to claim that Greece continues to be committed to staying on track. We think the troika will finally recommend providing the next loan installment to cover upcoming Greek debt payments, and we therefore assign a low probability to a default event occurring within the next few weeks. Until the next review is due by December, there will be continued political noise from the core countries about the need to allow a Greek default, but we think this is not going to materialize as long as the country is equipped with sufficient funds to cover its scheduled payments. By December, Greece will most likely be materially behind targets, and we think that most officials in Europe will have come to terms with the fact that Greece cannot be rescued without reducing its debt burden. However, fear of contagion may still trigger another loan installment in case the planned EFSF upgrade is not approved by all member countries by then. Therefore, we view a default by December as possible, but not as the most likely timing. Should Greece remain solvent into 2012, we believe that it is highly likely to default until the end of March.

**Consequences for Greek bonds**

We maintain our frequently published view that Greece's debt burden needs to be reduced to about 30% of its current nominal values to facilitate a sustainable recovery. Any lower cut being decided in a restructuring would not put the country on a sustainable debt path. However, we think other weaker Eurozone countries would not support taking a massive cut on their loans to Greece, just to put the country in a fiscally stronger position than they are in themselves. Therefore, a first Greek restructuring will most likely include too-small haircuts, and restructured debt would still trade at a large discount to new par values (if there is secondary market liquidity in these securities at all).

Currently, Greek bonds maturing between 2013 and 2040 trade at cash prices of 44% to 33%. This may appear close to our ultimate recovery value estimate of 30%; however, once a default is announced those bonds would most likely trade at a discount to expected recovery values. We think bonds may trade down to levels of 15%-20%, and speculative investors hoping for a gain from there may need to be prepared to hold on to an illiquid investment for a period of several years, during which the defaulted securities would not pay any interest.

**A Greek Eurozone exit is highly unlikely**

Another aspect sending bond prices lower currently is the pending uncertainty about a potential exit of Greece from the Eurozone, which would in our view require a larger haircut on its euro-denominated debt. Restructured debt would need to be offered in a new currency, which would depreciate massively against the euro or may not be convertible at all. In addition, Greece would in our view require a longer adjustment period to return to fiscal stability compared to a default within the Eurozone. Overall, we assign a very low probability to a Greek Eurozone exit. In the absence of any enforceable exit mechanism in the Eurozone, this can only be a decision by the country itself. As long as some form of support is available to Greece within the Eurozone, including support to recover from a debt default, it would be entirely irrational for the country to leave voluntarily or give in to political pressure to leave. Political initiatives to provide for an exit rule in EU treaties are, in our view, clumsy attempts to gain voters' support within core countries. Each EU country would need to support such a new rule, including Greece and the other peripheral countries.

## Portugal and Ireland – on track, but weak

Both Portugal and Ireland passed their recent support program reviews and therefore did not receive much attention during the recent market turmoil. We refrained from a Sell recommendation on Ireland throughout this crisis and suggested short-term Irish bonds to aggressive investors. While a lasting recovery is unlikely in the current environment, we think Ireland has demonstrated a strong commitment to meeting the requirements of its adjustment plan, and a default event is becoming increasingly unlikely. This has supported Irish bonds recently and while they have been trading at similar risk premiums than Portugal of up to 1200 basis points by July, Irish bonds are now trading at premiums around 700 basis points over German Bunds, whereas Portuguese bonds did not recover. We see limited near-term potential for further improvements and do not recommend taking new positions in Irish bonds now, but aggressive investors should maintain their existing holdings in Irish Treasury bonds maturing until mid-2013.

We think Portugal will face more difficulties with its adjustment program as the economy will most likely remain in recession in 2012. However, we expect the country to be able to stay close to the targets of its plan, which should ensure that further support loan installments prevent a default event at least until mid 2013, when the ESM will need to take over the financial support program for Portugal from the EFSF. If Portugal should continue to exhibit material fiscal weakness by then, a default would become increasingly likely. However, we think that the experience from a Greek default would be a strong incentive for both the Portuguese government and the official creditors to avoid another default within the Eurozone. Our scenario analysis shows that a sustainable fiscal turnaround continues to be highly challenging for Portugal, which is why we maintain our Sell recommendation for bonds maturing beyond June 2013 for the time being.

Immediately after a Greek default, we think secondary market liquidity will dry up for both Irish and Portuguese bonds, which may lead to further spread widening and valuation losses. However, as both countries do not need to tap bond markets, there is no direct impact on funding costs for the sovereign. Banks in both countries already primarily refer to the central bank and domestic sources for funding. Capital measures, which may be required to cover banks' losses on Greek bonds, may need to be provided by the government using funds from the official EU/IMF support package.

**Previous WMR publications on Portugal and Ireland**

- 18 July: "The debt crisis: Timing of a Greek default and contagion effects"
- 07 April: "The debt crisis: Portugal requests funding support "
- 25 March: "The debt crisis: Ireland, Portugal, Spain: Bond view"
- 25 January: "The debt crisis: Sovereign debt in the age of austerity"

Source: UBS WMR

## Spain and Italy – more austerity and counting on the ECB

Both countries have so far not requested any external support, but benefit from the ECB's decision to resume secondary market purchases of government bonds under the Securities Markets Program (SMP). Despite the ECB's sizeable purchases that initially lead to a recovery, risk premiums have risen back to their highs again recently. However, Italian 10-year yields are down from almost 6.2% in early August to 5.6% now, as German Bund yields have declined by more than 0.5% over this period. As we demonstrated in our 11 August publication, "Rescuing Italy and contagion to France", average interest costs for new debt of up to 6% are not endangering Italy's fiscal profile. At the same time, pressure from EU peers and the ECB to step up fiscal austerity has already triggered important political decisions to put Italian government finances on a more sustainable path. We think bond markets will not regain confidence in Italy and Spain easily, as investors putting their money at risk have painfully learned that governments have too often reneged on their promise to consolidate. Especially the recent back and forth approach by the Italian government with respect to the timing and extent of consolidation measures has undermined the government's credibility.

Risk premiums are currently higher for Italian compared to Spanish government bonds. Spain is running on plan with its adjustment program and, despite all remaining medium- to longer-term challenges, the current debt burden of Spain facilitates the country with sufficient time to address its structural problems, including high unemployment rates and an ailing domestic banking sector. We remain cautious about Spain in the longer run, but we think a sovereign default within a five-year horizon is highly unlikely. Italy has less room for fiscal manoeuvre given its higher debt burden, but we would also assign a very low probability to a default event within a five-year period.

While Spain's funding requirements may still be covered by an upsized EFSF, Italy is clearly too large to be supported within the existing stability facility. Therefore, we see fiscal austerity supported by ECB bond purchases as the only viable option to ease the pressure on Italy. While there continues to be resistance to such purchases within the ECB, we believe that political resistance against upsizing other support measures is even larger, and the ECB is currently the only institution in Europe that is able to act fast and in size. Italy is likely to remain a strong supporter of further fiscal integration within Europe, including the introduction of jointly guaranteed Eurobonds, as it would be a major near-term beneficiary of such a solution. However, we think Eurobonds are currently far from being politically acceptable in most core countries and their introduction would still be years away given the required legal and constitutional adjustments (see 17 August, "Eurobonds - today's resolution, tomorrow's doom.")

**If there is no default, why is this not a buying opportunity?**
At risk premiums over German Bunds of about 4%, investors may be tempted to buy Italian and Spanish bonds given our view of a medium-term default being unlikely. To assess possible fair risk premiums for both countries, we need to capture two major components that

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- 17 August: "The debt crisis: Eurobonds - today's resolution, tomorrow's doom"
- 11 August: "The debt crisis: Rescuing Italy and contagion to France"
- 18 July: "The debt crisis: Timing of a Greek default and contagion effects"
- 25 March: "The debt crisis: Ireland, Portugal, Spain: Bond view"
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Source: UBS WMR

investors need to be compensated for, which are credit risk and liquidity risk. In times of high uncertainty, investors have a strong preference for highly liquid assets. Comparing German Bund and Finnish or Dutch government bonds, we would expect the credit risk compensation to be lower for Finland and the Netherlands by about 20 basis points (bp) currently, reflecting their higher credit quality. However, bonds of both countries trade at about 50bp above Bunds, reflecting a liquidity premium of about 70bp. For Italy, which is rated A+ and may face further rating downgrades, a fair credit risk premium for longer-term debt should currently be about 140bp to 170bp. Therefore, a fair total risk premium for Italy should be 210bp to 240bp. Based on this rough calculation, Italian bonds appear cheap, but historical evidence has taught us that market valuations can stay irrational (in both directions) longer than someone trying to capture a mispricing may stay solvent. As long as both the path to consolidation for each peripheral country and the future of the Eurozone as a whole remain uncertain, there are more reasons for Italian and Spanish risk premiums to rise further than reasons for them to decline. In light of our expectation for a full Greek default, we expect a further increase in risk premiums and advise against investing in the bonds of Italy and Spain at this stage. However, we will monitor the risk/reward profile of Italian and Spanish government bonds and bonds of stronger corporates and financials from those countries and, depending on future developments, we may identify opportunities following a possible major sell-off.

## Belgium and France – fear of contagion

Both countries see their risk premiums at new highs currently with Belgium trading at 215bp over German Bunds and France trading around 80bp. In both cases, a default can almost be excluded over a five-year horizon, and possible credit rating downgrades over this horizon should be limited to one or two notches in an adverse scenario. Both Belgium and France share the structural concerns we have for Spain and Italy, but to a much lesser extent. However, both countries have provided much support to their banking sector in the financial crisis and will now most likely be required to support both their banks and other ailing Eurozone governments in the sovereign debt crisis. French banks have recently drawn a lot of market attention, due to their sizeable balance sheet exposures to peripheral assets and concerns over their ability to attract sufficient funding and liquidity.

In case of a Greek default, we can imagine risk premiums for both countries to increase strongly as support mechanisms for their banking systems need to be set up and financed. In such a period, support with ECB bond purchases may be required to maintain risk premiums at reasonable levels. Having said that, German interest rates may decline further in this environment, which eases the impact of rising risk premiums on effective funding costs. However, we understand that a large French risk premium over German Bunds is unpleasant from a political perspective and may lead the French government to push for measures to correct what it perceives as a mispricing.

**Previous WMR publications on Belgium and France**

- 17 August: "The debt crisis: Eurobonds - today's resolution, tomorrow's doom"
- 11 August: "The debt crisis: Rescuing Italy and contagion to France"
- 18 July: "The debt crisis: Timing of a Greek default and contagion effects"
- 25 January: "The debt crisis: Sovereign debt in the age of austerity"

Source: UBS WMR

## European banks will require support and receive it

We have published a detailed stress testing review on European banks recently (see 29 August, "Assessing stress levels in the financial market"). Our results show that possible capital needs are manageable considering the resources available from governments and, in case of weaker countries, an enhanced EFSF. However, the biggest concern is liquidity and funding as the interbank market would most probably face massive stress in case of a Greek default. To mitigate such stress and prevent banks from failing, governments will most likely revive the funding guarantee schemes used during the financial crisis, where banks could access market funding by paying a fee for a government guarantee on a new bond issue. However, such facilities would only work in countries of strong sovereign credit quality, like Germany, the Netherlands, Finland, Austria and possibly also France. In weaker countries, such support may need to be provided by special borrowing facilities from the national central bank (emergency liquidity assistance, ELA). In addition, we expect a lengthening of the Basel 3 phase-in period to grant banks more time to meet much stricter future regulatory requirements.

In any case, support would only be granted at a point in time when bonds and stocks of European banks are already under massive pressure and setting up new support mechanisms on a national level requires time, during which markets will remain highly nervous. We think that some smaller banks may be allowed to fail, with depositors being protected, and major banks will receive full support to prevent a systemic crisis. However, as governments feel the pain of having supported the sector just recently, governments may be hesitant to provide further support and may require share- and bondholders contributing to rescue actions. While this will be difficult in light of the current legal frameworks and national regulation, public discussions about demanding investor contributions may hurt valuations strongly in the short term.

**Previous WMR publications on Financials**

- 29 August: "Assessing stress levels in the financial market"
- 11 August: "The debt crisis: Rescuing Italy and contagion to France"
- 18 July: "The debt crisis: Timing of a Greek default and contagion effects"

Source: UBS WMR

# Appendix

## Global Disclaimer