OBSERVATION

TD Economics

January 9, 2015

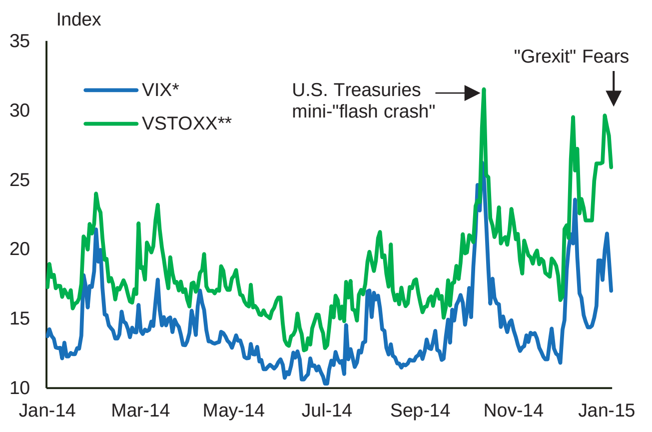
ASSESSING THE RISKS FROM RUSSIA, GREECE AND THE EUROPEAN CENTRAL BANK

Highlights

- Key developments in Europe have raised financial market volatility so far in 2015. There are increased worries that political change in Greece could lead it to exit the euro area. Meanwhile, Russia's economy appears to be on the verge of a deep recession, given the steep drop in oil prices and economic sanctions imposed on the country.
- TD Economics believes a Greek exit from the euro area remains a low probability event. If the anti-austerity party wins, the most likely outcome will be tough talks with the Troika. This could raise financial market volatility temporarily, but ultimately the most Greece is likely to obtain is a debt restructuring, such as extending maturities.
- Russia is headed into a deep recession, while the fall in the rouble will boost inflation. This will have negative implications for other countries through trade and financial linkages. However, it is unlikely to trigger a broader financial crisis beyond its borders.
- The ECB is caught between a rock and a hard place. It is signaling that it intends to provide more stimulus. This would likely require QE on a broader scale, which can only be achieved through purchases of sovereign debt. However, the ECB has political constraints on its ability to deliver this, and as a result may underwhelm markets. Although the ECB has limited scope to boost growth, the key issue is whether QE can re-anchor inflation expectations.
- The bottom line is that economic, financial and political risk in Europe could mean bouts of increased financial market volatility in 2015. While one could envision some very negative scenarios playing out, the most likely path is that Europe will muddle its way through its financial challenges.

In recent months, financial markets have become more anxious about several key developments in Europe. First, there are increased worries that political change in Greece could lead it to renegotiate the terms of its bailout agreement, and in a worst case scenario, exit the euro area. The latter outcome could revive the eurozone financial crisis, as markets would bet on who is next. Second, there are worries about the fallout of a deep recession in Russia, which seems inevitable due to the precipitous drop in oil prices and the pain from economic sanctions. The concern is that Russia's woes could have repercussions for other nations through trade and financial linkages.

CHART 1. VOLATILITY IN EARLY 2015 ALREADY NEAR ITS HIGH FROM LAST YEAR



Source: Chicago Board Options Exchange. *CBOE Volatility Index. **EURO STOXX 50 Volatility Index.

These risks compound the challenges for the European Central Bank (ECB). Economic growth in the eurozone remains very weak, and the economy has now fallen into deflation. While there are widespread expectations that the ECB will embark upon greater monetary stimulus, there are severe political limitations on the central bank that could check its capacity to boost growth and inflation. In other words, quantitative easing by the ECB may

Craig Alexander, SVP & Chief Economist, 416-982-8064
Andrew Labelle, Economist, 416-982-2556
Diarra Sourang, PRM, Economic Analyst 416-982-2559

be essential to re-anchor inflation expectations, but markets could be disappointed by the extent of stimulus from the ECB and its limited impact on economic conditions.

All these developments have the potential to increase financial market volatility, which we have seen in recent days (see Chart 1). TD economics believes that the volatility will be periodic, and at times could be quite pronounced. While there is a probability of deeply negative outcomes, the most likely course is for Europe to muddle through its challenges. However, the process will be far from smooth. Market worries will intensify and then abate as developments unfold.

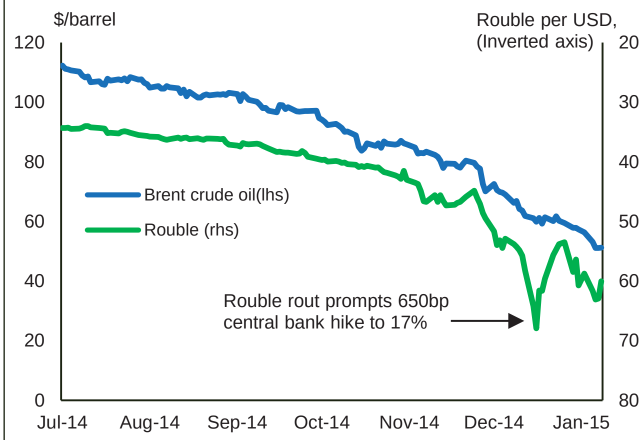
A perfect storm hits Russia

The Russian economy was assailed by a number of issues in 2014. Alongside other emerging market currencies, the rouble has fallen relative to the USD, on the back of strong U.S. economic data and possible tightening of monetary policy by the Federal Reserve. However, the rouble has suffered more than other currencies due to sanctions from the European Union and the United States. In response to the Ukrainian crisis, some of Russia's largest companies have been banned from debt financing on Western capital markets for periods longer than 30 days. Moreover, the sharp fall in oil prices has pushed the rouble lower reflecting the strong relationship between Russian state revenues and oil exports. Indeed, Brent oil prices have tumbled more than 50% over the past year, and are now just above $50 per barrel. These issues led to a slide in the rouble, which lost 45% of its value in 2014 (See Chart 2). Economic sanctions and a lower currency have also triggered fears about the ability of Russian companies to fulfill their foreign-denominated debt obligations.

The economic fallout of the oil shock, sanctions and lower rouble are now playing out. Russia is headed into a deep economic contraction combined with high inflation. According to the most recent data, Gross Domestic Product (GDP) contracted 0.5% Y/Y in November 2014 and inflation surged to 11.4%, far above the Central Bank of Russia's (CBR) medium term goal of 4%. Meanwhile, the banking system is experiencing the effects of sanctions as evidenced by the government rescue of one of Russia's largest banks (National Bank Trust). The CBR has previously stated that the economy could contract 4.5-4.7% in 2015 should oil prices average $60/barrel, and oil prices are now well below that level.

Concerns have now extended to the potential spillovers

CHART 2. ROUBLE SLIDE HAS NEARLY MIRRORED THAT OF OIL PRICES



Source: Bloomberg.

of a Russian economic debacle. Total Russian external debt was $679.4bn as of Q3 2014. Some European banks are under scrutiny due to their high loan exposures to Russia. As of Q2, 2014, eurozone banks had claims on Russia to the tune of $111.3bn and other exposures of $20.9bn. Of this total, most is linked to safer euro area countries, with 44.6% tied to the banking system in France, 20.9% in Italy and 15.7% in Germany. Financial markets appear to view Raiffeisen Bank (Austria), Société Générale (France) and UniCredit (Italy) as among the most exposed, with the result that their shares have lost at least 10% of their value since early December.

Beyond financial losses, risks are also present on the commercial front, as the combination of the rouble depreciation and sanctions may hurt European exports to Russia. Indeed, French and German goods exports to Russia were down 12.8% and 16.5% in value, respectively, year-to-date through October. The impact for machinery and transport equipment exporters in each country is even greater, with declines of 13.6% and 21%, respectively, over the same period. That being said, for Europe's largest economy, Germany, lower goods exports to Russia have been offset elsewhere, with exports gaining 3.6% overall year-to-date through October. France, on the other hand, has seen its total goods exports decline 0.4% in value.

While this illustrates some of the financial and commercial linkages between Russia and the eurozone, the current situation is unlikely to trigger a large scale crisis beyond Russia's borders. General government debt is low at 13.0% of GDP. The risks to Russia's economy are greater in terms of foreign currency requirements. Foreign reserves have declined by over $100bn over the past year, but remain sizeable at $390bn as of Dec. 26th 2014. They are also more than enough to cover the $120bn in external payments expected by the central bank in 2015, only a portion of which will need to be paid from reserves. Finally, the CBR has shown a willingness to use unconventional policy measures to ensure the stability of the Russian financial system, and honor its national companies' external payments.

For Russia itself, a further tumbling in oil prices from current levels and a further escalation in tensions in Ukraine would exacerbate the crisis considerably. The former would reduce U.S. dollar inflows, which exposes the rouble to further declines, while the latter could exacerbate capital outflows. The country's economic fortunes will depend on the evolution of the price of oil and the situation in Ukraine. As such, Russia remains a key source of risk to the global economic outlook. In the meantime, periodic episodes of volatility emanating from Russia can be expected as it struggles to support its economy. For example, it could lose its investment grade status held with Standard & Poor's.

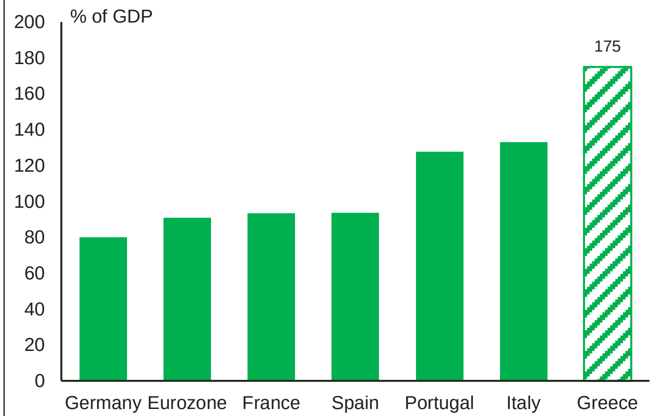
Greece: Should I stay or should I go?

While Russia is of importance for the EU, all eyes are now on Greece. The Greek Parliament failed to reach the consensus needed to elect a President after the third and last round of voting on Dec. 29th 2014. As a result, the Parliament was dissolved and early elections are set to take place on January 25th, 2015. This failure of the ruling coalition to get its presidential candidate elected is perceived as a rejection of the austerity measures adopted by the Greek government.

The situation is all the more critical given that the Greek anti-austerity party, Syriza, is leading the polls and could win the next election. The party leader, Alexis Tsipras, intends to renegotiate the memorandum signed with the Troika (i.e. the ECB, the European Commission (EC) and the International Monetary Fund (IMF)) regarding austerity measures in exchange for the country's previous financial bailout. Although Syriza has recently softened its stance, the party has previously discussed writing down the majority of the country's public debt and re-instating some public benefits, among other things. The main concern is that if Syriza wins the election and cannot negotiate effectively with the Troika, it could lead to Greece exiting the eurozone.

On one hand, there is little evidence that Syriza would actually opt for a default of Greek debt, especially when its leader has toned down its rhetoric. On the other hand, it appears that eurozone members, such as Germany, are less inclined to keep Greece within the monetary union at all costs. Some have argued that a Greek exit no longer poses a systemic risk to the European currency, and that the European Stability Mechanism could adequately handle any country's banking crisis in the event of a Greek default, thus mitigating contagion effects. In our view, such opinions are very short-sighted, as a Greek exit from the euro would trigger financial market speculation of who else might exit.

CHART 3. PUBLIC DEBT AS A SHARE OF GDP IN 2013



Source: Bloomberg. Public debt refers to General government debt.

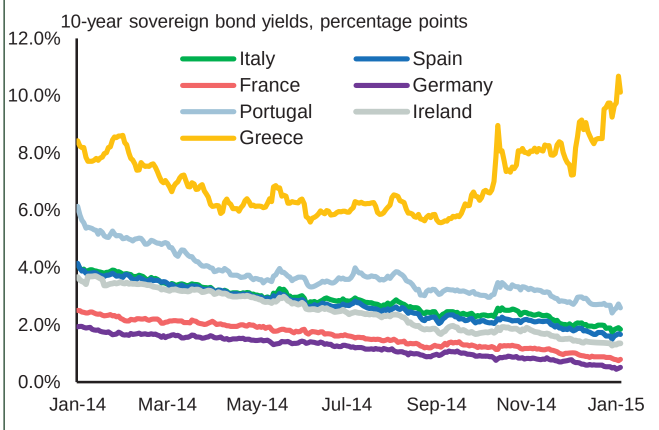
The financial market anxiety over the prospective regime change in Greece can be readily observed in European markets. The Euro Stoxx Index has lost 5% since December 1st. Moreover, investors have rushed once more to safer debt, as evidenced by the drop in German and French 10-year bond yields, while Greek bond yields have reached their highest level since 2013, exceeding 10%. It has also contributed to the rally in U.S. Treasuries – the global fixed income safe haven.

The sustainability of Greece's debt at stake

Taking a step back and looking at the state of Greece's finances, it does appear that some form of further restructuring in sovereign debt may be required. Debt as a ratio of GDP stands at a shocking 175%, a majority of which is owed to the ECB, IMF and other eurozone countries through bilateral loans (See Chart 3). Over €12bn is due in the first semester of 2015, including a €8.1 billion payment to the IMF, with more than €33bn due for the year as a whole. Given the precarious state of Greek's finances and the greater odds that an anti-bailout and anti-austerity party may be elected, it is little wonder then that Greek bond yields have risen.

Meanwhile, Greece's current bailout program expires on February 28th, 2015, a few weeks after the elections are

CHART 4. MARKET VIEWS RISKS AS LARGELY ISOLATED TO GREECE



Source: Bloomberg, TD Economics.

held. Should a new agreement fail to be reached with the Troika, then Greek banks could lose access to ECB liquidity operations. Greek banks could turn to their national central bank for the Emergency Liquidity Assistance program, but they would have to pay a higher rate of interest than they currently do, and this would also be subject to ECB approval. All this to say, continued Greece participation in the bailout program will likely be necessary.

Overall, a Greek exit from the euro remains a low probability event – the consequences for Greece and the eurozone would likely be too severe. Similarly, given the large sums owed to the IMF and the ECB, it is also in the interest of the creditors to come to an agreement with Greece. However, there is a fine line to walk for the IMF, ECB and the EU, as any compromise with Greece could lead other European countries to demand similar debt restructuring.

For now, markets participants seem to perceive the risks as mainly internal to Greece (see Chart 4) and do not expect that a crisis could have major effects on other European countries. This is partly due to the relatively small size of the Greek economy. In 2013, Greece represented only 1.9% of the eurozone GDP. One can see that market fears are largely constrained to Greece, since long-term borrowing rates remain low for other countries with fiscal challenges, such as: Spain, Italy and Portugal. Overall, financial and economic indicators of other peripheral countries are in better shape than Greece's, hence the lower risk sentiment towards their economies.

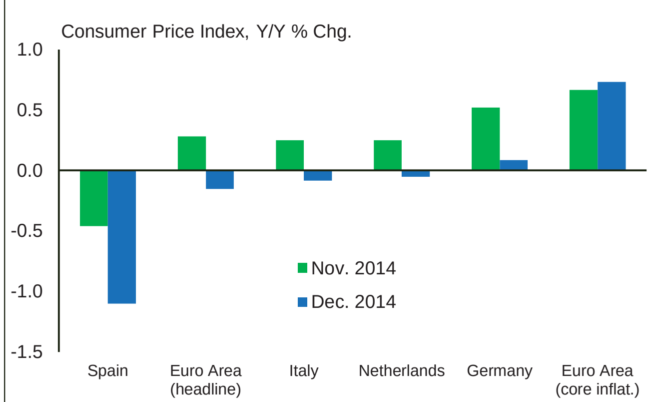
Finally, eurozone banks in other countries have limited claims on Greece, with other peripheral countries having reduced their exposure. As of Q2 2014, eurozone banks had foreign claims on Greece's private and public sector to the tune $19.5bn, and other exposures of $5.7bn. Of this amount, 66% was owed to the banking system in Germany, 16% to France and 6% to Italy. Moreover, it is important to stress that capitalization of the European banks has improved significantly in recent years, again tempering the risk.

The most likely scenario is that Greece's challenges will not trigger a return of the euro crisis. But, the risks of that particularly negative outcome are far from zero. Accordingly, financial markets are likely to remain anxious in the coming weeks, and potentially months. Again, at some point, Greece will likely need another debt restructuring, and there is always the possibility that this will not happen smoothly. The broader challenge of slow growth and high unemployment in the euro area also continues to run the risk of triggering a backlash against austerity, which could herald the return of the euro crisis. The implication is that economic and financial risk in the eurozone will remain a source of financial market volatility.

Important challenges lie in store for the ECB

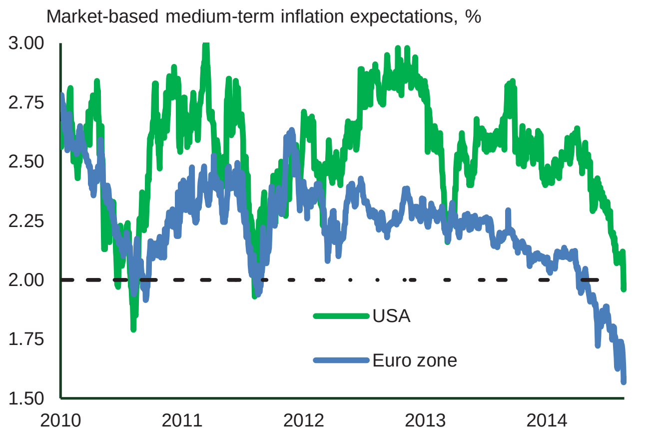
The risks in Greece add to the challenges faced by the ECB at its upcoming meeting on January 22nd. Economic growth in the eurozone remains remarkably weak, and is failing to materially lower the unemployment rate – 11.5% in November for the euro area, and much higher in some of the member countries. The fall in oil prices has pushed the monetary union into deflation, with the consumer price falling -0.2% Y/Y in December (See Chart 5). Although core price growth excluding food and energy remains positive, medium-term inflation expectations continue to decline and the risks of a deflationary mindset taking hold are elevated (See Chart 6).

CHART 5. HEADLINE INFLATION HAS TURNED NEGATIVE ACROSS THE EURO AREA



Source: Eurostat, Haver. Euro zone members for which December data is available.

CHART 6. MEDIUM-TERM INFLATION EXPECTATIONS ARE BECOMING UNANCHORED IN THE EURO ZONE



Source: Bloomberg. *Measured by 5-year forward 5-year inflation expectations.

The ECB is currently caught between a rock and a hard place in the sense that while it has signaled its intention to provide more stimulus to the European economy, political constraints limit its ability to launch a full scale quantitative easing (QE) program that includes government (i.e. sovereign) bonds. The current political situation in Greece complicates the ECB's plans. The ECB could decide to purchase only investment grade (IG) bonds - thereby excluding Greek bonds rated below the IG threshold. However, this would undermine the principle of solidarity within the monetary union, would likely precipitate a further sell-off in Greek bonds, and would provide further ammunition to anti-euro parties in Greece. Alternatively, if the ECB purchases the sovereign bonds of all eurozone countries, it runs the risk of losing money on the non-investment grade categories, particularly with risks surrounding a possible Greek exit.

Another element to watch is the upcoming preliminary decision on January 14th by the European Court of Justice on the legality of the ECB's Outright Monetary Transactions (OMT) program – the sovereign debt purchasing program which has yet to be used but whose presence has helped keep European bond yields low since its announcement in 2012. A favorable ruling is expected, but if restrictions to the OMT were announced, these could then also apply to sovereign bond purchases under QE. For instance, sovereign bonds purchases may only be allowed if the bonds are held on the balance of each euro area member's national central bank. In this scenario, the market's response may be harder to gauge. In the end, the ECB is likely to come through with a smorgasbord approach, broadening its purchases to corporate bonds and some form of sovereign bonds. However, given the political constraints, the measures announced may underwhelm markets.

Nevertheless, it is inevitable that the ECB will have to deploy more stimulus. While weak economic growth and deflation are a concern, the greatest threat to the outlook is falling inflation expectations. The deflation at the moment partly reflects the temporary impact of falling oil prices. There is good reason to believe that 12 months from now, the effect will dissipate. The bigger issue is that inflation expectations in Continental Europe appear to have become unanchored and are falling. If consumers and businesses expect lower prices in the future, they will delay purchases and will incorporate lower prices into wages and contracts. This can create a sustained deflationary period that is extremely difficult to break out of. Accordingly, the ECB cannot ignore this threat. The reality is that the ECB is likely unable to change the trajectory of the eurozone economy with QE. Interest rates are already so low; the bond buying will have limited stimulative impact. The wealth effects from QE will also be more felt by higher income individuals, constraining the boost to expenditure. But, that does not mean QE will be ineffective. In fact, it is essential to preventing deflationary expectations. The ECB has said that 'it will do whatever it takes' and now it has to put its money where its mouth is.

Bottom line

European developments pose a key risk to the global economic and financial outlook. The trials and tribulations of Russia will grab headlines and could raise financial market volatility. At this point, TD Economics does not believe that Russia's economic and financial problems will trigger a broader crisis, but the lower oil prices go, the higher the risks become. Greece is also much in the news these days, and will remain so until after the upcoming election and negotiations with the Troika. Odds are that Greece will not be a catalyst for a renewed euro crisis. Nevertheless, Greece is a case study in how fiscal austerity could trigger a backlash that could have long lasting implications. It is also likely that further debt restructuring is eventually needed in the eurozone. While one could envision some very negative scenarios playing out, and TD Economics will be monitoring the risks very closely, the most likely path is that Europe will muddle its way through the challenges. It may sound counterintuitive to investors, but periods of heightened financial anxiety could be beneficial, as they have the potential to push policymakers to take actions that ensure that the worst outcomes do not occur.