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## Europe's Divergent Futures

*The eurozone stands at a crossroads.*

*In the second of a series of Q&A articles accompanying PIMCO's recent Secular Forum discussion, head of European portfolio management Andrew Balls discusses the response of European leaders to the crisis in Greece and other major factors influencing the future of the eurozone.*

**Q. Europe is in the midst of a fiscal deflationary drag and sovereign debt crisis. Is there a risk the eurozone will fracture?**

A. The crisis currently besetting the eurozone illustrates a more general global secular trend of a flatter distribution of possible outcomes and fatter tails. By that I mean there is a very wide range of possible outcomes for the eurozone rather than a single, dominant baseline scenario. The range of possible outcomes includes the preservation of the current eurozone, albeit as a weaker entity unless urgent progress is made on a deeper fiscal union, or one or more eurozone members restructuring their debt and also the possible exit of a current member country.

Such possible outcomes, some unthinkable mere months ago, are being openly debated

and reflected in some market prices. Moreover, the European sovereign problem has started to contaminate the European banking sector and in turn the global economy, owing to capital market and trade links and the rise in risk aversion we have witnessed in global markets.

**Q. The eurozone's stabilization package, administered by the governments of the European Union (EU) and the European Central Bank (ECB), was an unprecedented policy response. Are European policymakers handling the crisis appropriately?**

A. Clearly this is a very difficult crisis to handle: Policymakers have rapidly moved from a situation that was unthinkable just a few months ago to a situation that they are now forced to contemplate. Related to this, there are big coordination problems to grapple with in the eurozone resulting from an economic area that has a monetary union but not a fiscal union. As the eurozone does not have a federal system, countries in the euro area do not benefit from automatic stabilizers to cushion the impact of asymmetric shocks.

That said, the eurozone leaders have not done a very good job of getting ahead of the crisis, and the problem has spread, from Greece to its

southern European neighbors and increasingly to the banking system and the core eurozone countries. And even though eurozone leaders did, eventually, catch up in May with the announcement of a program that was impressive in terms of its size and that suggested political commitment, the crisis has morphed from earlier concerns over liquidity and funding to questions over longer-term solvency and the structural challenges that countries face.

Meanwhile, the ECB commitment seems half-hearted. It has been dragged in as a reluctant buyer of government bonds that assumes credit risk – an inherently fiscal action – and those purchases are raising accusations that banks and other investors are being allowed to exit their positions at the ECB's expense. Going forward, it's an open question whether the ECB will be forced to be more aggressive in using its balance sheet to prop up the European sovereign market.

None of this is welcome news to those investors who 10 years into the eurozone project had assumed away the differentiation among eurozone member issuers. They are being rudely reminded that they hold credit risk, not just interest rate risk, in their portfolios.

**Q. So to what extent are the long-term solvency issues of peripheral eurozone countries being addressed?**

A. There have been a variety of responses to date. We have seen plans that, on paper, would pave the way for very extensive fiscal adjustment in Greece and some of the other

peripheral countries, but we also have a situation where some governments have been slow to respond to the problems, suggesting a lack of appreciation for the severity of the problem and the challenge facing them. The discrepancy in responses has highlighted the issue of assessing countries on a standalone basis rather than as a member of the eurozone club. Indeed, in the case of one or more eurozone countries, there is significant risk of sovereign debt restructuring over the secular outlook.

Ultimately, we may witness the separation of countries from the eurozone – those nations that face the greatest challenges on their debt dynamics, growth outcomes and competitiveness, thereby allowing them to restructure and take deeper steps to regain competitiveness. In many ways this would make sense, since it would allow the eurozone to focus its support on a smaller group of countries. But this would be very difficult to do politically, not least since the eurozone is seen by many as a chiefly political project to promote greater unity in continental Europe.

**Q. What is your outlook for the euro over the longer-term?**

A. Our outlook for the euro, in addition to issues already outlined facing Europe, is influenced by the outlook for growth and interest rates in the eurozone. We also think growth in the eurozone will be weak compared with emerging markets and also versus many of the Organization for Economic Cooperation and Development (OECD) countries. As a result, the ECB will have to keep interest rates low for

a longer period. This is likely to have implications for interest rate differentials versus other currencies.

The strong version of this view is that the euro will continue to weaken against emerging market currencies, reflecting relative growth dynamics in Europe versus better prospects in emerging market countries. Against the U.S. dollar, the euro does not yet look cheap in terms of standard valuation metrics. And at minimum the eurozone crisis is likely to deter investors, including government sector investors, from increasing their exposure in the eurozone and could lead to a reduction in euro exposure.

**Q. How does PIMCO's secular outlook for the eurozone translate into investment strategy?**

A. As we've stressed, the global economy is on a bumpy journey to a New Normal – an uneven road to an uncertain destination, characterized by the likelihood of broader distribution and fatter tails. Nowhere is this clearer than in the case of the eurozone.

Given the range of possible outcomes, we remain cautious on European sovereign risk. The government interventions may eventually

be successful in bailing in private sector investors. But because these interventions have been focused on liquidity provision and also given the multiple challenges and the wide range of possible outcomes, we think it is prudent to remain underweight European sovereign risk and to wait for evidence that countries with stressed debt dynamics can deliver on fiscal consolidation without undermining growth in their economies.

We will look both within and beyond Europe for higher-quality securities where we think we can achieve similar or superior risk-adjusted returns. We remain positive on core duration and German bunds. But given the potential for eurozone governments or the ECB to be drawn deeper and deeper into providing support, we do not see German bunds as offering significant advantages over the secular horizon compared with U.S. Treasuries.

**Thank you, Andrew.**

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