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Subject: BBH MarketView: Europe: Contagion and Containment

Tolstoy tells us in the first line of Anna Karenina that "Happy families are all alike; every unhappy family is unhappy in its own way." This is directly applicable to Europe. It is easy to tar all (growing) peripheral countries with the same brush, but that risks over simplification and the faulty analysis may generate poor investment decisions.

Given recent developments in the European debt and derivatives market many policy makers and observers see the problem as one of contagion. The unresolved Greece 2.0 assistance is weighing on sentiment and dragging down the other peripheral countries.

There is something to be said of this contagion, but arguably the problem is bigger than that. If it were simply contagion, addressing Greece would solve the problem. This seems increasingly not to be the case. Rather than contagion, the challenge may Europe's failure to contain the crisis.

The key difference is the recognition that like Tolstoy's unhappy families, each country in the peripheral has their own tale of woe. If Greece 2.0 does materialize, one cannot be confident that the European debt crisis would be resolved. To the contrary, the risk is that Greece 2.0 leads to more pressure on Ireland and Portugal not less. And Spain and Italy have their own set of challenges that will not be resolved by another package for Greece. Many focus on some straight forward debt metrics, but each country has a different mix between public and private debts, different proportions held domestically and internationally, and different primary budget positions.

We have consistently been skeptical of the German/ECB narrative that the problem in Europe is that peripheral countries simply lack fiscal discipline. While this does seem to fit the facts in Greece, it doesn't in the other countries. Ireland, for example, did not have a fiscal problem until it decided, with the urging from European leaders, to provide an unlimited guarantee to senior bank` bond holders. Ireland's older model, which fueled its Celtic Tiger status was built largely an export oriented model and attracting foreign direct investment. This broke down after the tech bubble imploded. The housing boom replaced the earlier export model.

Unlike Spain and Ireland, Portugal did not have a housing bubble. Neither did Italy. The problem in Italy and Portugal is the combination of debt and slow growth. While Italy's debt is largely public, Portuguese private debt exceeds public debt by a factor of nearly 3. A bit more than half of Italian debt is owned by domestic institutions, but recently there have been reports that Italian banks are growing more reluctant to extend exposures. Whereas Spain's two

large banks have diversified outside of Spain, which offers protection and appear to be well capitalized, Italy's largest banks seem to be less well capitalized.

In terms of primary budget balances (budget excluding debt servicing costs), Italy is the only one of the peripheral countries that has a surplus. Under appreciated, is that Italy is one of only a few countries in the euro zone that has primary budget surplus. The others are Luxembourg, Belgium, Germany. Italy's primary budget surplus of 1.8% of GDP last year was the highest in the region.

Beneath the economy lies political weakness. Governments in the periphery are particularly weak. Spain has still has a minority government. Portugal and Ireland have governments not even a year old. Greece's Socialists have a slim majority in parliament but have begun lagging in the polls. Italy's politics are also messy. Berlusconi has survived various votes of confidences and a number of legislative setbacks. Most immediate is the apparent split between the prime minister and the finance minister and concern that parliament may not support the multi-year 40 bln euro savings package.

Contagion may have been the operative principle earlier on in the European debt crisis. Yet, increasingly, it does not appear as contagion as much as the failure to contain the crisis. The European debt crisis is part of the crisis that began in late 2007. The end of the credit cycle hits all debtors. In the US it was real estate, households, and state/local governments. In Europe, it was real estate and local (Spain and Italy) governments and national governments. European policy makers have stood in the way of de-leveraging, but have not managed to contain it.

Efforts to get the private sector to participate but not to accept a hair cut--(default) has run aground. This has once again opened the door to more dramatic possibilities. If the EU allows Greece to default, the risk that it will let others default rises, not declines.

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