



Can Pigs Fly?

The Sovereign Debt Crisis and What it means for Markets, Part 1

Summary

- **A Greek tragedy**
- **The devil's dilemma: massive government debt or an economic depression**
- **Will Greece's austerity package work**
- **Is outside help the solution?**

Introduction

The concerns that are currently surrounding the issue of sovereign debt are definitely the topic du jour in the financial markets. The crisis has centred on Greece but it has wider implications, hence the acronym in the title Portugal, Ireland (or/and Italy), Greece and Spain (PIGS). Indeed, the partial default by Dubai focused investors' minds on the issue of sovereign default back in November last year, although this was largely self-contained in that Dubai was one of several Emirates that could ultimately rely on the support of the financially stronger Abu Dhabi. Following a short period of stand off Dubai received the aid it was seeking but the problems facing Greece, and potentially other larger countries with large public debt, are much more intractable.

Although geographically Greece and other southern European countries are most vulnerable the issue has far reaching ramifications. This note, and the second part that follows, will explore the wider implications of the effect of Greece defaulting on its debt and how it can avoid this nemesis. All developed economies have seen a significant deterioration in their public finances, and none more so than the UK and so this issue is especially poignant for us. This will be considered together with what it means for asset markets going forward. The first part will look at the case of Greece and its wider implications within the EU and the subsequent piece will analyse the global implications with particular reference to the UK and whether it could spell the end of the bull market.

How has a sovereign debt crisis evolved?

The global recession that we are slowly emerging from has been a financially rather than the more normal economically induced crisis. The main issue has been the vast accumulation of debt which was seen as an easy route to making a fortune for the private and corporate sector alike. By the time the credit crunch arrived in mid 2007 savings ratios in many developed economies were at record lows as consumers overreached themselves in an unprecedented way. The leveraging of the private sector was encouraged and fostered by the banks that were aggressively competing to provide loans on thin margins and little or no collateral.

This all meant that when the bubble burst, the private sector was heavily geared at a time when asset prices were plunging. This would make economic recovery a difficult and protracted process as it would require the private sector to deleverage at a time when the economy was deep in recession and unemployment was rising (it still is). At the same time the public sector's balance sheet had also been deteriorating despite several years of economic growth. Government spending had continued to rise and tax receipts have not been sufficient to compensate. Most developed economies entered this crisis with historically elevated public sector deficit ratios to GDP as well as high overall levels of public debt.

Clearly, governments would like to have embarked on a period of frugality and retrenchment themselves to repair their own balance sheets but they faced a big dilemma. If the State tried to restore order to its own finances it would run the risk of tipping the economy over from recession into depression but if it tried to reflate the economy through aggressive monetary

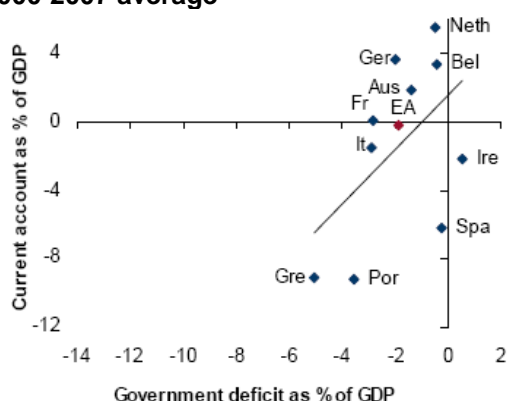


and fiscal measures it would only lead to a further deterioration of its own balance sheet and this, in turn, could shackle growth for years ahead.

This equated to the devil's dilemma for the authorities but in deciding their response to the crisis, policy makers drew on the experience of the 1930's when it is widely accepted that the depression was brought about by a policy of financial rectitude, including the classical economic theory of trying to balance the Government's books and maintaining the gold standard in international currency markets. Therefore, led by the US Federal Reserve Governor, Ben Bernanke, who studied the Great Depression and the long depression in Japan since 1990 as an academic, central banks in all developed economies embarked on an aggressive State-sponsored expansionary programme. It led to a revival of Keynesian economics that to some extent had been discredited in the 1980s and 90s with the governments playing a much greater interventionist role in seeking to revive economic growth.

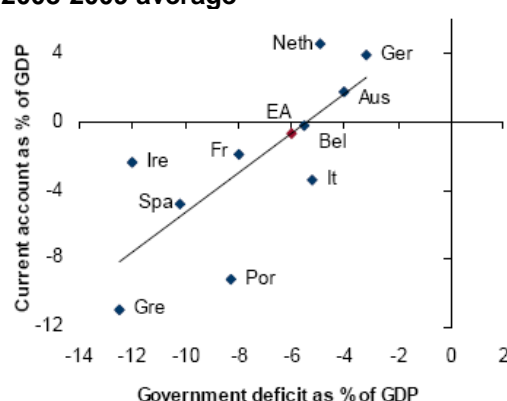
The effect of this policy is that, although private sector debt has indeed come down as the consumer has deleveraged, the largesse of the State has meant that the debt and borrowing requirements of western governments have ballooned to unprecedented peace time levels. This is shown in the two charts below that show the government and trade deficits for European economies. In the more recent chart note how Greece, Portugal and Spain stand out.

The twin deficit in the 2000s...
2000-2007 average



Source: Credit Suisse

... and in the last couple of years
2008-2009 average



Source: Credit Suisse

In order to maintain the momentum of the recovery the public sector has been prepared to assume more and more debt to the extent that rating agencies have been becoming increasingly concerned about the credit worthiness of some of the more indebted nations. *In effect, there has been a transfer of risk from the private to the public sector.* Initially, the banks were successfully rescued but latterly the assumption of vastly increased debt levels by governments has greatly weakened their balance sheets. The ramifications of this are now being increasingly reflected in markets but as long ago as September 2008, right at the beginning of the current crisis, Iceland was the first country to blow a chill wind through the financial community as it became insolvent.

When Iceland effectively went bust only an emergency bailout of \$6 billion from the IMF could keep the economy functioning normally. The case of Iceland reflected the exceptionally deep involvement of the country's banks (even by the standards of other western economies) in relation to the tiny size of the economy. Many Icelandic banks were offering double digit interest rate returns, well above what could be achieved elsewhere, and when the bubble burst the liabilities of the banks were too big for the Government to guarantee. However, Iceland was regarded as a special case because firstly the economy was insignificant in a global context and it was not a member state of a union such as the EU. Secondly, the problem with its sovereign debt status was caused more by the behaviour of the private sector banks than the response of the authorities post the onset of the credit crunch.



The issue of sovereign debt remained relatively quiescent for a year until it was thrown into the spotlight in November 2009 by the news that debt-laden Dubai was unable to meet its interest bill. The size of the debt was relatively small at \$80bn but it spooked the market because it was unclear who the creditors were and, more importantly, whether the financially stronger Emirate, Abu Dhabi, would provide a rescue package. In the event Dubai was bailed out by its stronger neighbour to preserve the integrity of the UAE but the incident once again highlighted how over-indebted and vulnerable some countries had become as a result of the financial crisis.

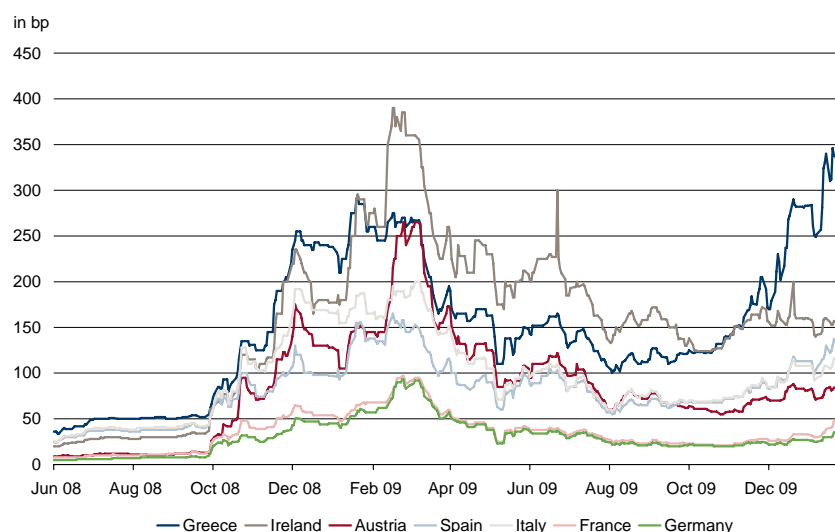
Partly as a result of the Dubai crisis the financial markets focused next on other vulnerable countries that had a risk, however remote, of default. These included the UK, and even the US, because of the parlous state of their public purses, but the countries that were seen as the most vulnerable were the smaller southern European economies, in particular Greece. This takes us up-to-date and we can now explore why the issue of Greece is so much more important in the context of international politics and finance than either Iceland or Dubai.

Why Greece is so important for financial markets

Greece, like Iceland and Dubai, is a relatively small country in terms of national output representing less than 3% of the Eurozone GDP. By comparison, California represents about 14% of US GDP. However, it is not the size of the economy or, indeed, the debt that is important; it is the potential fall out and collateral damage that could occur if it defaults. Like Dubai, Greece is part of a federation of countries, the European Union, but unlike Dubai it is part of a collection of states with a standardised system of laws with, critically, a single common currency. As such, the destiny of Greece is as much an issue for the Eurozone as it is for Greece itself.

The fear is that if Greece defaults, or is even bailed out by other member states of the EU, then it will have a domino effect similar to the bankruptcy of Lehman Brothers and the subsequent dislocation of financial markets that almost broke the banking system. The other members of the PIGS, are also facing a formidable challenge in restructuring the public finances of their respective states while trying to avoid lapsing into deep recession.

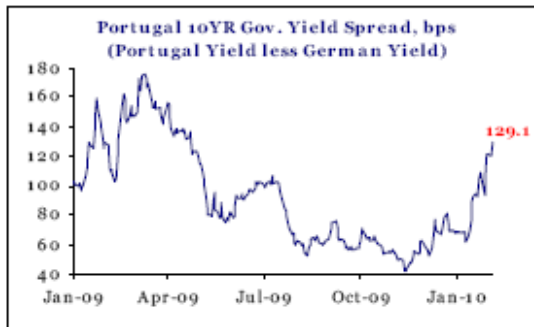
Often financial markets lead events rather than vice versa and this is what has been happening in recent weeks and the escalation of the crisis, to some extent, is outside Greece's and the EU's control. The financial markets' barometer of anxiety of a country's sovereign debt is reflected in its bond yields and credit default swaps (CDS) spreads. The CDS are effectively an insurance against default for holders of the debt and lately these have spiked up to record levels as shown in the graph below:



Source: Credit Suisse



The same is true of the Greek government bond yields that have risen to a record premium to the German bonds, the most credit worthy in the Eurozone. The charts below show the bond yields of the financially weaker Euro nations and illustrate how the recent crisis has been mirrored by an increasing spread versus the German bund yields.



Source: Strategas

As part of the recent austerity package announced by the Greek government it sold a tranche of new bonds in an auction to raise €8bn of finance but had to pay a massive 6.2% interest on the coupon. This did not stop the bond yield rising further to 7.2% in the days that followed! This is a case of the cart leading the horse with financial markets moving in anticipation of events that have not happened. However, the re-pricing of risk by the markets, in turn, has increased the chance that the event(s) the markets want to avoid will happen. With the cost of Greek debt now so high, it will increasingly handicap the government's efforts to implement a financial rescue package, and so the vicious circle will continue.



You will notice in the graph above that it is not only Greek CDS spreads that have risen sharply in recent weeks. This is because if Greece fails the markets will move in predatory fashion to the next vulnerable nation, probably Portugal or Spain. While Greece is relatively small, Spain is one of the major Eurozone economies and is four times the size of Greece. In this respect, Greece is Bear Stearns as Spain is Lehman's both chronologically and in size. This is why Greece cannot be allowed to default: the contagion would not only spread to other Eurozone countries but would threaten the existence of the European Currency Union itself.

Can Greece restore financial stability while remaining a member of the Eurozone?

In the ordinary event of a country threatened with default there are various options available to it:

- It can impose an austerity package by cutting spending, raising taxes and finding other ways of improving the public sector balance sheet
- It can seek help from elsewhere (usually the IMF as in the case of Iceland but if it is a member for a federation like Dubai or Greece, from other members of the governing body of the Union)
- It can devalue the currency and make its products more competitive
- It can inflate away the value of the debt by increasing the money supply and debasing the currency
- It can default

As stated in the section above, the last option, default, is not desirable not only for the country concerned but also for the EU and beyond. The third and fourth options are not only not desirable but also not possible while Greece is a member of the Eurozone. It cannot unilaterally devalue the Euro and the monetary policy is subject to the authority of the ECB that is set on a low inflationary financial environment, despite the stimulus packages that have been in place during the recession.

This leaves the choice of toughing it out with financially stringent measures even at the risk of the economy slipping back into recession or going cap in hand to the other member states of the EU, the IMF or even an external investor such as China.

In response to the worsening situation, Greece recently announced a stability package with the aim of reducing the budget deficit to 2.8% in 2012 from 12.7% in 2009. This has been approved by the European Commission but confidence in the plan was not helped by the revelation that much of the economic data from the Greek finance ministry could not be relied upon but, in any event, the package is ambitious relying on major tax reforms. The danger is that if the economy slows too much it will be insufficient and deep structural reforms will be necessary or a bail out from other EU members. The problem is compounded by deep seated resistance from the Greek population who are hostile to the government's proposals. This is in contrast to the austerity package implemented in Ireland that has the broad support of the electorate who feel collective guilt for the country's financial travails. If much of the Greek population goes on strike then the plan will not be workable.

It is clear that Greece is caught in the straitjacket of EU membership and there is no easy solution. I believe the stability measures that have been announced will be insufficient to avert the debt crisis in the absence of being able to devalue its currency to stimulate its export sector to offset slowing internal demand. To reduce wages to improve competitiveness would result in an even worse downturn and a sharp increase in the debt to GDP ratio. Currently, the economy appears on a course towards deep recession combined with social and political discontent unless some form of bail out is agreed.

Is the EU able to bail out a member state and is it legal?

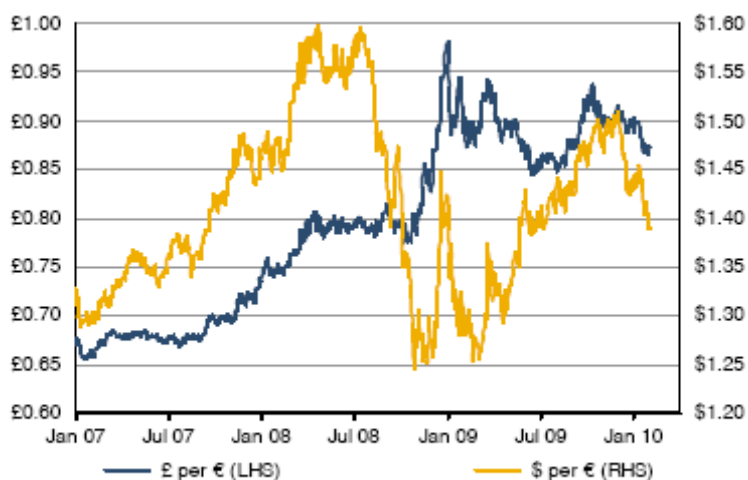
The second part of this question has been overshadowed during the sovereign debt debate with many commentators assuming that Germany and other financially stronger member states can step in and rescue their problem children within the Union. This is not the case because the European Union has a legal constitution that includes a *no bail out clause*. The clause is set out in Article 125 of the Treaty establishing the Union.



It rules that the sovereign debt of an EU member state cannot be bailed out by a European institution including another member state(s) or the ECB.

The issue of bail out is complicated by another Article, 122, that states that emergency assistance can be provided in certain conditions but, obviously, this has never been tested nor would the stronger member states want it to be invoked. A bail out would be unpopular with other members as it would set a dangerous precedent to other weaker economies and severely undermine the credibility of the EU constitution. What is clear is that under the EU constitution governments must keep their deficits below 3% of GDP. In addition to the stability package announced, other EU finance ministers have insisted that Greece must sort out its own problems and intimated that financial help would not be forthcoming. This is partly rhetoric to try and restore confidence in the financial markets but the EU will do everything it possibly can to avoid intervention.

It is the first major test for the currency union since its creation over a decade ago and were it to provide assistance it would not only undermine the political fabric of the EU but also weaken the Euro itself, which is the second most internationally traded currency after the dollar and is seen by some as an alternative reserve currency to the greenback. Certainly the weakness of the Euro on foreign exchange markets this year reflects those fears, as the chart below shows



Source: *Altium Securities, Datastream*

An alternative would be for Greece to go to the IMF for assistance. like Iceland. and many other countries (including the UK in the late 1970s) that face financial disaster. Again, the EU would wish to avoid this if at all possible because Greece and the other weaker nations is a collective problem for the Federation to work out itself. Seeking external help would also undermine the political and economic fabric of the Union and create a dangerous precedent for the future.

What are the implications for other countries in the EU?

Sovereign debt is not just an EU problem; it is a global issue with the UK and, to a lesser extent, even the US vulnerable. The chart below shows some the debt ratios to GDP and illustrates how widespread the countries with high debt ratios are:



General government net financial liabilities

Per cent of nominal GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
France	35.1	36.7	41.8	44.2	45.3	43.2	37.2	34.0	41.9	49.5	57.0
Germany	34.4	36.7	40.8	43.5	47.5	49.8	48.0	43.0	45.1	51.1	56.9
Greece	88.7	92.9	94.7	87.8	87.7	84.4	76.7	69.8	72.7	78.7	83.5
Ireland	16.4	12.9	13.9	11.6	9.0	6.7	1.4	-0.2	11.1	23.8	38.0
Italy	95.7	95.8	95.7	92.7	92.5	93.7	90.6	87.1	89.7	97.8	102.1
Portugal	28.5	30.5	34.6	37.2	42.1	45.0	44.0	44.1	47.9	56.4	62.6
Spain	44.2	41.5	40.3	36.8	34.6	30.2	24.0	18.9	22.9	32.8	42.6
United Kingdom	26.8	23.2	23.7	23.9	25.8	27.2	27.8	28.8	33.6	47.5	61.0
United States	36.0	35.3	37.9	41.2	42.8	43.2	42.3	43.0	48.2	59.0	69.3
Euro area	47.3	47.6	49.5	50.5	51.0	50.9	47.7	43.6	44.7	51.5	57.9
Total OECD	37.6	37.5	39.5	41.4	42.7	42.7	40.9	39.1	42.2	51.1	59.5

Source: OECD Economic Outlook 85 database.

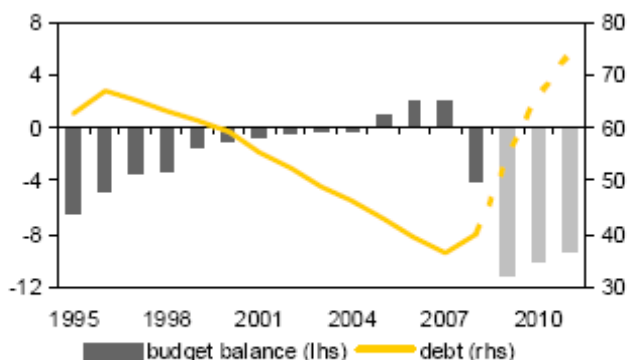
I believe that the most likely outcome is for the Greek rescue plan, having been approved by the EU, to prove insufficient to solve the crisis. It is probable that Greece will lapse into deep recession and there will also be great internal resistance to such an austere programme. If this happens it will represent the acid test for financial markets because the crisis could quickly spread to other countries within and even outside the Eurozone.

After Greece, the two most vulnerable countries in the Eurozone are Spain and Portugal. Ireland and Italy are also in a weak position but in the former a series of measures have been announced that, unlike in Greece, have been accepted by its people and are seen as sufficient to restore financial stability after a period of retrenchment (the financial markets also indicate this is so); in Italy, although the debt ratio to GDP is high the public sector deficit is under much better control than the Iberian countries or Greece.

Spain is the country that markets really fear because it is a large country in the context of the EU (unlike Portugal) and it is in such a mess following the unprecedented and unsustainable construction boom in the years preceding the crisis. Public debt is still fairly low because Spain's balance sheet benefited from the booming economy from the early 2000's and actually produced annual surpluses for the Exchequer in 2005-7 (see bar chart below). However, as can also be seen there has been a rapid deterioration in the Government's balance sheet and the public sector deficit to GDP has mushroomed to 11.4% and is growing. The authorities have announced a fiscal consolidation package to reduce the deficit to less than 3% of GDP by 2013 (in line with EU rules of 3% or less) but, just as in Greece, it will be a Herculean task to achieve this.

Spain is benefiting from the years of plenty

Public debt and budget balance in % of GDP, 2009 to 2011 forecast of the EU Commission



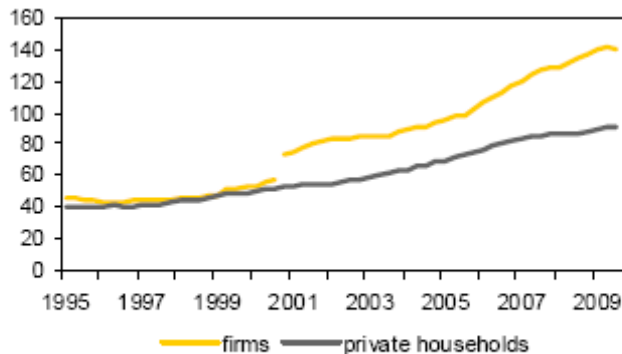
Sources: EU commission, Commerzbank Research



Spain is the weakest of all the Eurozone countries and is the only one that is not expected to grow in 2010. This reflects the slowdown in the construction sector that is likely to continue for some time and allied with 20% unemployment will mean that growth will be very difficult to achieve, despite a global recovery. The chart below also shows the level of debt the corporate and private sector have assumed during the last 15 years and, therefore, there is a long period of adjustment to come.

Strong rise in debt

Debt of non-financial firms (excl trade credits) and private households in % of GDP



Sources: Banco d'Espagna, Global Insight, Commerzbank Research

Just like Greece, Spain faces a long struggle to repair its public finances and the period of adjustment will mean the likelihood of a recession continuing into 2011. As it becomes evident that Greece, Spain and other European countries will struggle to restore financial stability under the proposed rescue packages, markets are likely to reflect these concerns by rising bond yields and CDS spreads. Therefore, I contend that it will be necessary for some of these countries to seek and receive external assistance to avoid default or, even worse for the EU, withdrawal from the Union.

I think it is likely that the EU politicians will want to achieve a 'solution' within the framework of the Federation and so recourse to the IMF will be the less preferred option. As explained above, the legal constitution is untested and unclear and so some sort of compromise is likely that avoids violating the article of no bail out while still providing emergency aid. The money may come from other European banks rather than the ECB itself as indicated in a front page article in the FT on January 29th. This might placate markets and that is what is important because it will reduce the risk premium and cost of capital for the vulnerable countries so making it easier for them to raise the money via bond issuance at a lower cost to finance the deficit. If confidence returns to Greece in this way, as the first test case, then a full blown sovereign debt crisis should be averted as yields and credit spreads come back in other countries.

Conclusion

The phrase 'Greek tragedy' has been used frequently in recent weeks in reference to the unfortunate chain of events unfolding in southern Europe. It does appear that Greece is caught between a rock and hard place whereby if it defaults it could spark an international financial crisis, similar to the bankruptcy of Lehman's in September 2008, but if it tries to implement a rescue package it is bound to fail because the economy will lapse into deep recession. The Greek government has announced a credible debt management strategy that has the support of Brussels but the resulting pain of protracted fiscal restraint will overwhelm the economy so another solution will have to be found.



Ted Scott on the wire

February 2010

I believe that Greece will not be allowed to default because the consequences of doing so are too dire. For the EU it is part of the vision of a wider monetary union and there is a broad political commitment to maintain its integrity. This has already been seen by the measures announced by Ireland and more recently in Spain and Portugal so it is clear that the politicians in Brussels will do whatever is necessary to keep the framework intact. Whether the solution means that the credibility of the Eurozone is weakened remains to be seen, but once it becomes clear that Greece will not be allowed to default (and by implication Portugal and Spain) then some confidence should return to the markets.

In future, the constitution needs to be amended to make the bail out of a nation in need of debt restructuring easier. Currently, the EU has a monetary union but is not united on fiscal and political issues; this contrasts to the US where the states are united in practice as well as name. Perhaps the EU should take note.

Ted Scott February 2010