The Sovereign Debt Crisis: Origins and Endgame

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The crisis in European sovereign debt markets grew acute following the October 2009 revelation that Greece's budget deficit, at nearly 13% of GDP, was more than twice as large as previously estimated. Its deeper origins, however, lie in regional disparities within the euro zone and in the fundamental contradiction of the entire euro experiment. Adopting the euro subjected member countries to a single monetary policy but did nothing to unify their fiscal policies. Euro members included "core" states (such as Germany) with dominant export sectors and tight fiscal policies and "peripheral" countries (such as Greece, Portugal and Spain) in which growth was driven by consumption or housing bubbles and where government finances were often loose. Despite the huge differences between the two groups, the European Central Bank's common monetary policy applied to all. This precluded any convergence between them and instead allowed regional imbalances to worsen.

Greece offers the most serious example of how the tensions inherent in the euro project have now come home to roost. The serious structural problems of the Greek economy were worsened by the terms on which it adopted the currency in 2001. An unrealistic exchange rate made exports uncompetitive in world markets, while lower interest rates enabled by euro membership encouraged debt-financed consumption growth. As a result, Greece ran external deficits averaging 9% of GDP between 2001 and 2009, peaking at nearly 15% in 2008. (By comparison, the U.S. current account deficit peaked at 6% of GDP in 2006 but shrank to 3% of GDP last year. International economists normally view external deficits above 5% of GDP as unsustainable.) Yet Greece's euro membership enabled it to finance these external deficits easily until last year.

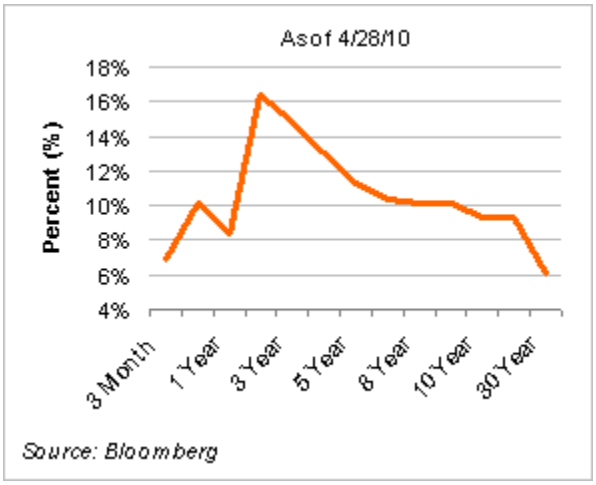
The negative side of euro membership for Greece became apparent once bond markets began to balk at financing its larger-than-expected budget deficit. A country such as the U.S. or U.K. that controls both fiscal and monetary policies can devalue its currency if its exchange rate makes it globally uncompetitive. If it chooses, its central bank can finance a portion of its budget deficit through monetization, albeit at the cost of domestic inflation. Such policy alternatives are not available to Greece because its monetary policy is set by the European Central Bank. Greece can only deal with its poor global competitiveness by reducing costs through painful wage and benefit cuts or productivity growth, and it can only deal with its budget deficit through tough spending cuts and tax increases. A widely acknowledged history of poor tax compliance makes the latter course particularly difficult.

Rising Global Risks

Greece's longer-term problems were compounded by the need to refinance large chunks of maturing debt in the next few years: it needed to repay €35 billion this year and more than €40 billion in each of 2011 and 2012. The growing realization in the face of rising yield spreads that Greece could not raise these funds in the global capital markets prompted euro zone member states and the International Monetary Fund to structure a loan package for the country in early April (which was subsequently expanded to €110 billion in early May).

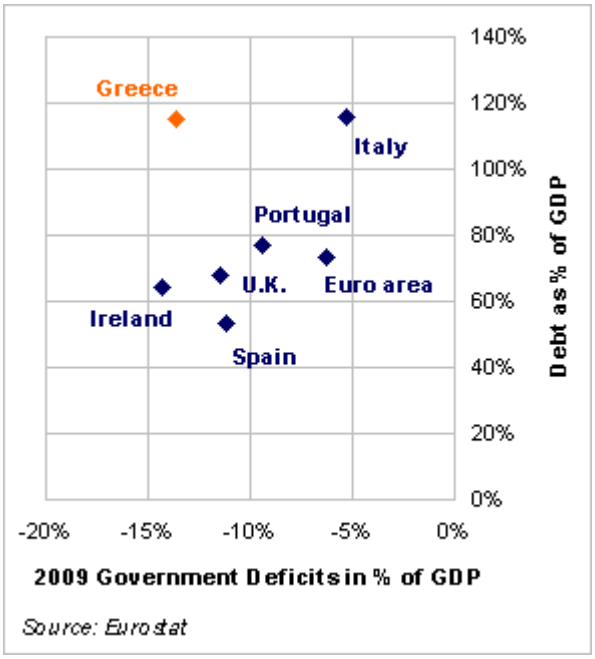
Announcement of this program caused only a temporary decline in Greek spreads, however, and they have since continued to soar. By late April, ten-year bond yields had reached 9% and one-year credit default swap spreads stretched to over 1,200 basis points. However, even the original, smaller loan package faced fierce political opposition in Germany, where a major regional election is set for May 9 and legal challenges to the package have been threatened, as well as intense resistance in Greece itself, where strikes and violent demonstrations have multiplied. At this juncture, it is difficult to imagine that the Greek crisis can be resolved without a debt restructuring, involving at least a lengthening of maturities, or an actual default. Such an outcome has essentially been discounted by markets, as the Greek yield curve illustrates.

Sovereign yield curve: Greece

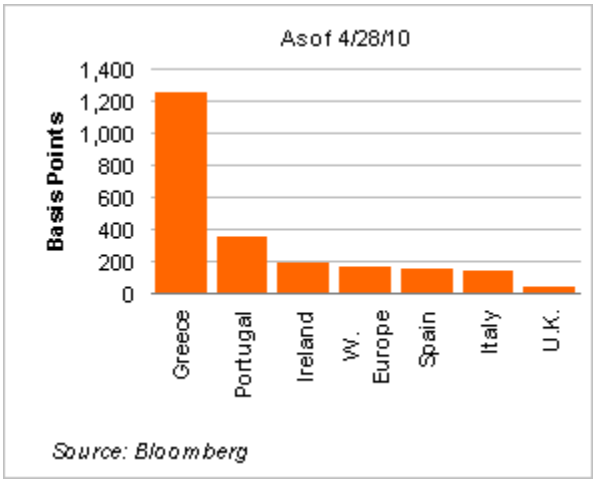


Southern Europe's other "peripheral" countries, Portugal and Spain, have broadly similar problems to Greece, although neither case is as serious. Portugal's current account deficit has narrowed from 12% of GDP in 2008 to about 9% last year, while Spain's has shrunk from 9% of GDP in 2007 to below 6%. While both have large budget deficits and Portugal faces significant refinancing requirements in the next year, their public-debt-to-GDP ratios are much smaller than Greece's. Yet as Greece's debt crisis has grown more acute, markets have become increasingly wary of Spain and Portugal, driving yields and CDS spreads higher for both countries. Greece's debt rating has now been moved below investment grade, while Spain and Portugal have been downgraded.

Problems in other "peripherals" are not as serious



One-year CDS spreads



Our primary concern is that international assistance to Greece has come too late and proven too small to prevent restructuring or default, and that such an event could set off a round of global financial turbulence similar to what followed the Lehman Brothers bankruptcy in 2008. Such a dislocation could easily jeopardize the economic recovery that has been underway for the past few quarters. At the same time, the ability of policy makers to respond aggressively to economic dislocation is much smaller now than it was in 2008.

The debt crisis may also affect the ability of U.S.-based multinational companies to continue beating earnings estimates. The euro has fallen by about 8% versus the U.S. dollar since the beginning of the year and is now below the levels assumed by many companies when developing 2010 earnings guidance. United Technologies, for example, assumed a $1.48 dollar/euro exchange rate at the beginning of 2010. Several other U.S.-based multinationals

have recently suggested that the euro's decline will prove a headwind to earnings — either by making their products less competitive or through direct translation effects. If sustained, these headwinds may require analysts to lower S&P 500 earnings estimates.

The S&P 500 declined by more than 8% between mid-January and early February as the debt crisis first sparked fears of financial contagion. We do not view a renewed global financial crisis as our base case forecast, but we do expect investors to remain cautious on risky assets until they gain greater clarity that Europe's debt crisis can be resolved without more serious repercussions. ■