



“Breaking Up is Hard to Do”

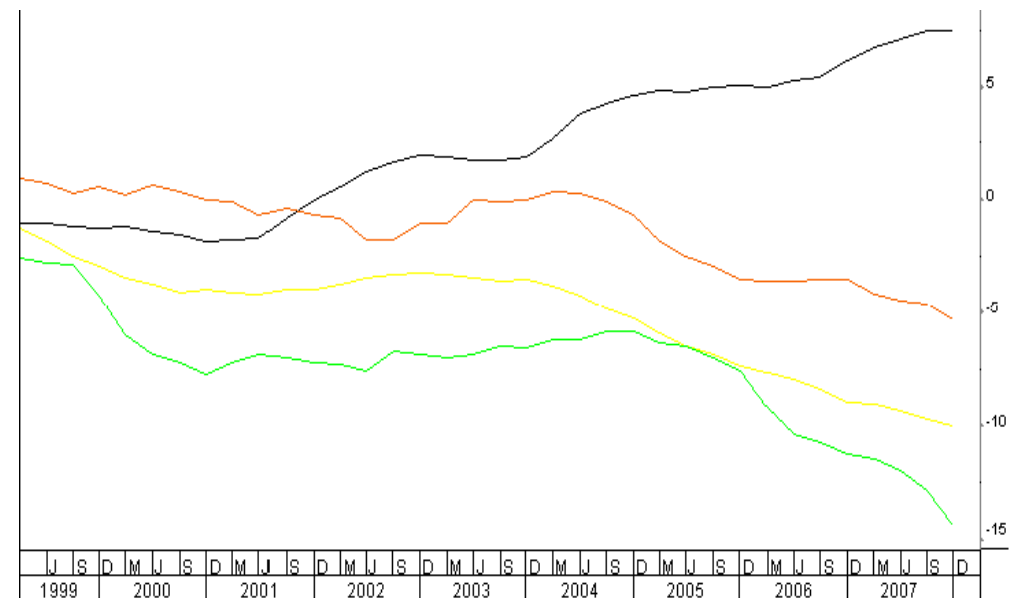
Anatomy of the Euroland Sovereign Debt Crisis

Anatomy of a Sovereign Debt Crisis

Sowing the seeds ...

- Sub-optimal currency zone
- Fixity of notional variables (currencies and interest rates) rather than real
- Real economic divergences
- Size build-up in net external liabilities, bank intermediated

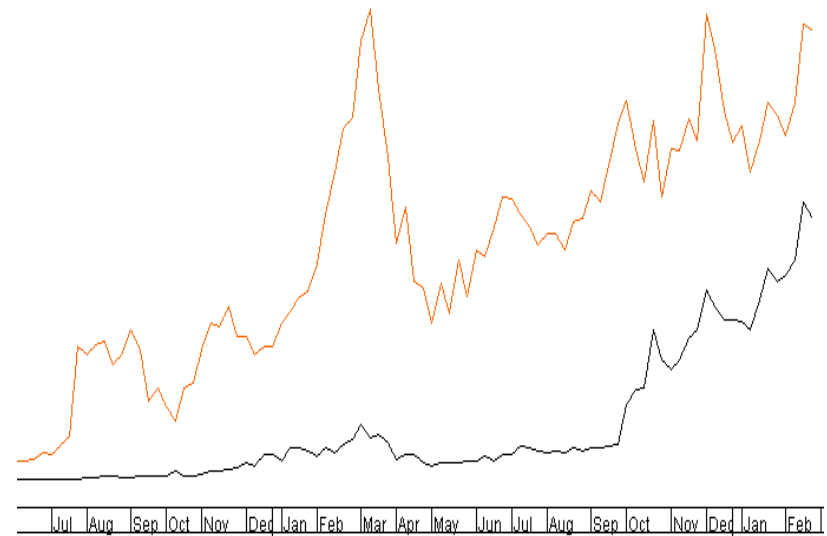
Current Acc Bal (Ger, Irl, Spa, Gre, % GDP)



Exposing the flaws ...

- Global credit crisis
- Home capital bias
- “Twin-deficit” vulnerabilities
- Socialization of bank credit risk

Europe Senior Financial & Sovereign CDS

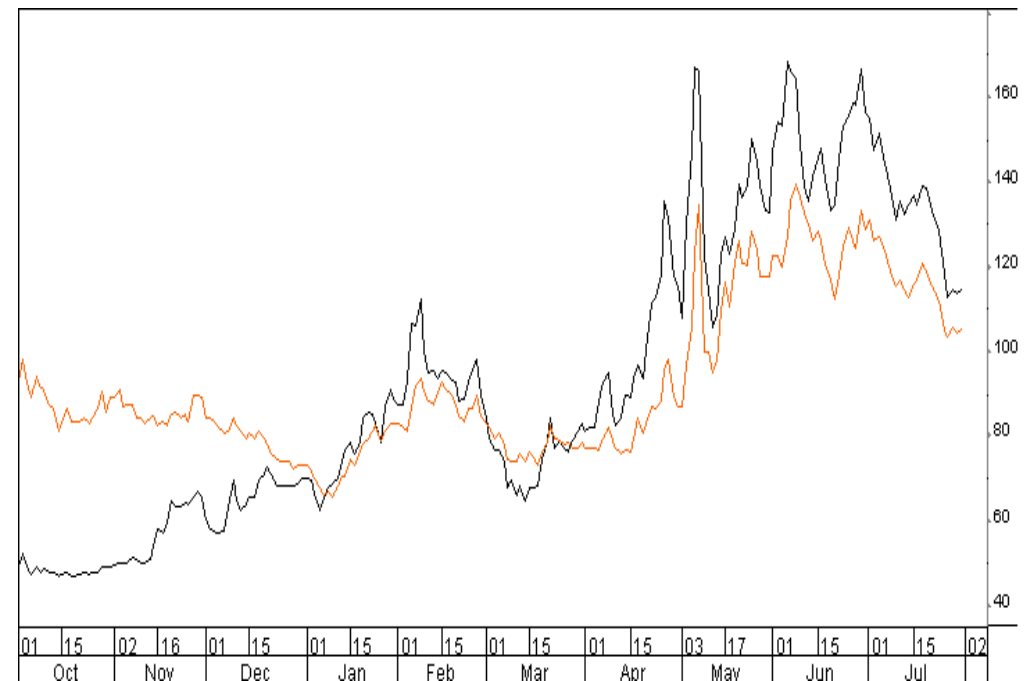


Anatomy of a Sovereign Debt Crisis

Greece is the word ...

- Greek tragedy catalyst for a growing obsession with sovereign default risk
- Denial of market access for funding a critical contagion effect
- Distinction between solvency and liquidity risks necessarily blurred

European Sovereign & Main CDS



Political diagnosis ...

- “Core” politicians convinced that the crisis is one of solvency rather than liquidity, caused by the profligacy of “peripheral” nations
- Such view framing the populist debate (amongst *Bild* readers et al) and impeding the necessary buy-in for crisis resolution
- “Bailout” pejoratives reinforcing the antipathy towards a collective response

Public Debt Metrics

%GDP	Gross Debt		Budget Balance		Struct Primary Bal	
	2010	2011	2010	2011	2010	2011
Germany	83	83	-3.3	-2.3	-0.3	0.0
Japan	220	229	-9.5	-10.0	-6.4	-7.0
UK	80	86	-10.4	-8.6	-5.7	-3.6
US	92	100	-10.6	-10.8	-5.9	-6.4
Portugal	93	100	-9.1	-5.9	-3.0	0.6
Ireland	96	111	-32.4	-10.0	-6.7	-4.5
Italy	119	120	-4.6	-4.3	1.3	1.7
Greece	143	152	-10.5	-7.4	-3.1	0.3
Spain	60	64	-9.2	-6.2	-6.1	-3.1

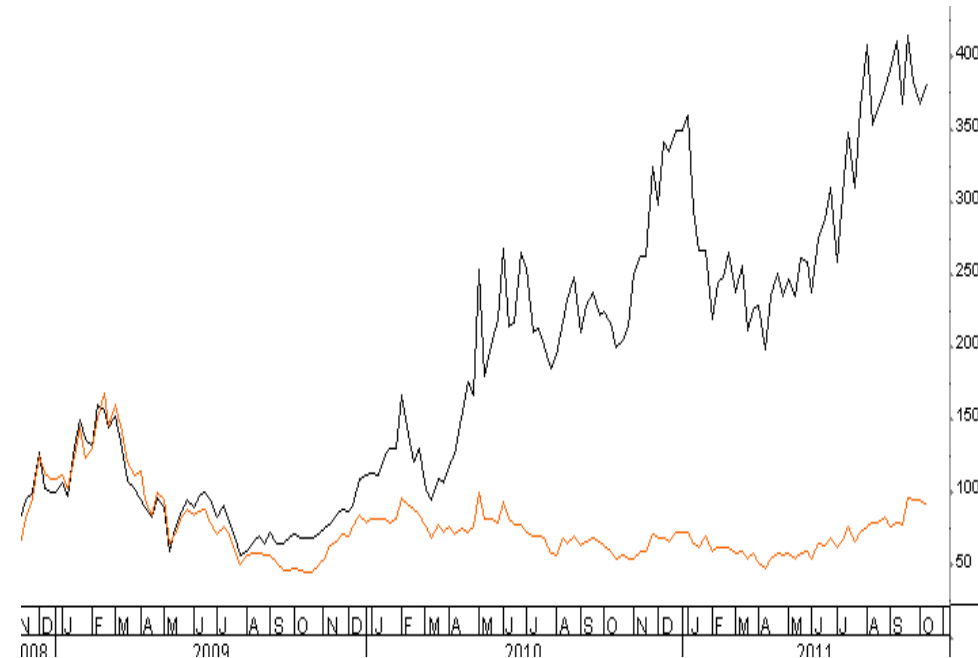
Source: IMF

Anatomy of a Sovereign Debt Crisis

Market diagnosis ...

- Markets implicitly viewing the crisis as being that of diminished refinancing capability for EMU sovereigns no longer in control of their own issued currency
- CDS pricing thus reflects liquidity risk masquerading as solvency risk
- EFSF designed to eradicate liquidity risk, but embedded “PSI” risk in permanent ESM restoring default threat

Spanish & UK Sovereign CDS

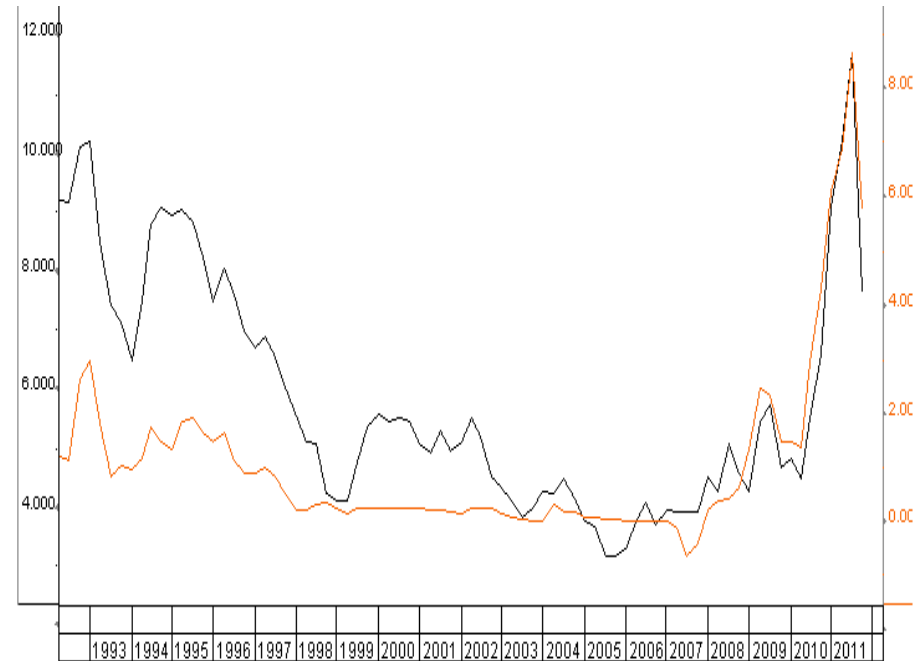


Anatomy of a Sovereign Debt Crisis

European Destabilisation Mechanism (EDM) ...

- EMU now as inherently unstable as was the ERM before it
- Then, a system of strong and weak currencies, the latter susceptible to devaluation risk, all the more so if subjected to speculative attack
- Now, a system of strong and weak credits, the latter susceptible to “restructuring” risk, all the more so if subjected to speculative/political attack

Irish 10 yr Yields & Spreads

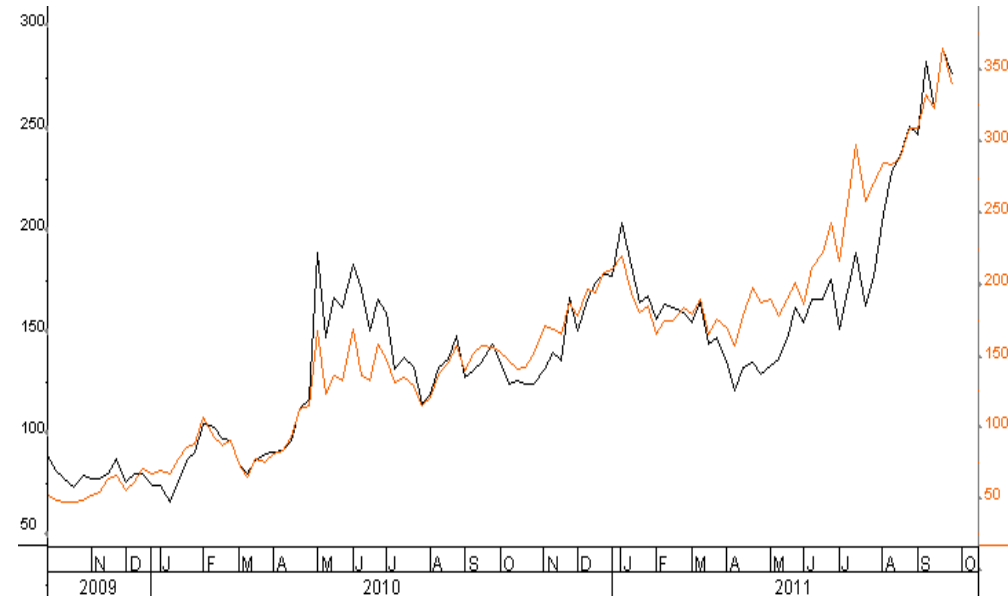


Anatomy of a Sovereign Debt Crisis

Sovereign/Bank nexus in adverse feedback loop ...

- Erosion of Sovereign “risk free” status reviving solvency concerns on bank balance sheets
- Natural bank sponsorship of sovereign funding requirements eroding in consequence
- Sovereign willingness/ability to sustain solvency support for banking systems increasingly questioned (not least by rating agencies)

European Senior Financial & Sovereign CDS



Break-up risk ...

- Dysfunctional EMU exciting political and popular discourse re country secession and/or system break-up
- Cost/benefit assertions typically grossly misrepresented
- Hotel California ... *“you can check out ... but you can never leave”*
- Lisbon Treaty provides legal framework for a country to leave the EU, but not EMU; adoption of the Euro is *“irrevocable”*

*“I am sure the Euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created”
(Romano Prodi, 15 Dec, 2001)*

Barroso's road map ...

- A decisive response to the problems in Greece
- Enhancing euro area backstop against the crisis
- A co-ordinated approach to strengthen European banks
- Frontloading stability and growth enhancing policies
- Building robust and integrated economic governance for the future

“We must finally get ahead of the curve, and break the vicious circle between doubts on the sustainability of sovereign debt, the stability of the banking system and the European Union’s growth prospects (Jose-Manuel Barroso, 12 Oct, 2011)”

Binary outcomes ...

- Greek debt restructuring – voluntary or involuntary
- Firewalls to limit contagion – effective or ineffective
- Bank recapitalisations – credible or incredible
- Sovereign creditworthiness – raised or lowered
- Global financial conditions – stabilised or destabilised

“The main issue for us is to restore the credibility of the sovereign signature – we do not have the backstop if we have a new crisis (Jean-Claude Trichet 11 Oct, 2011)”

Conclusion ...

- Key political constraint is ongoing misdiagnosis of Euroland sovereign debt crisis as a solvency rather than liquidity problem
- Populist resentment reinforced by “bailout” caricature
- Crisis now more about governance than debt, and the ramifications have gone global
- A “Grand Bargain” keenly awaited, with aspirations to strengthen the collective solvency of the Euroland area
- Collective solvency to be enhanced by collective liquidity support
- A sub-optimal currency zone then rendered more optimal

“Greece’s problems must be solved not by restructuring its debt, but by restructuring its country (George Papandreou, 15 April 2011)”

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