SRI-KUMAR
GLOBAL STRATEGIES

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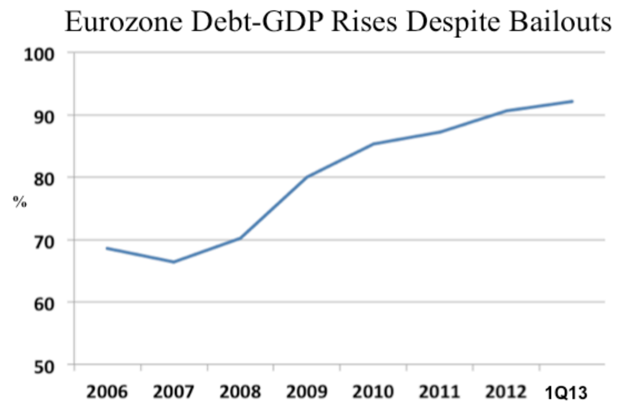
Europe: Still On Slow Boil

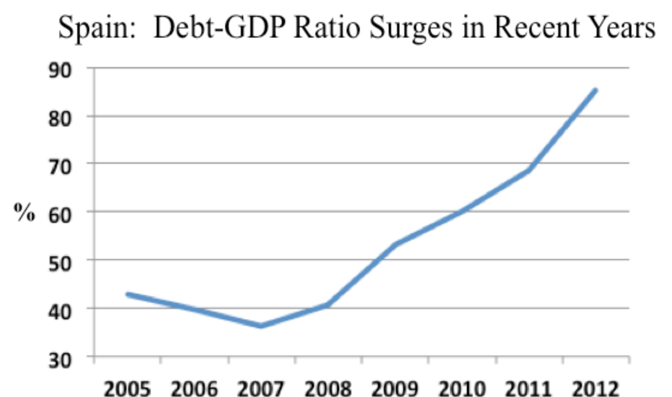
The Eurozone has been relatively free of eruptions for several months. There have been mini-crises -- the defeat of the reform-oriented Monti government in elections in February, and the confiscation of deposits and introduction of exchange controls in Cyprus in March, to mention two. However, ECB President Mario Draghi's promise last year to purchase bonds, and to do whatever was necessary to save the euro, has substantially lowered debt yields and supported the currency. The hope was that this ECB strategy, known as Outright Monetary Transactions (OMT) would eventually facilitate the return to private credit markets of countries which had been bailed out - - Greece, Ireland and Portugal. Despite some debt issuances by Ireland, return to private capital markets remains a distant dream for the peripheral Eurozone nations.



Debt-related indicators are worsening

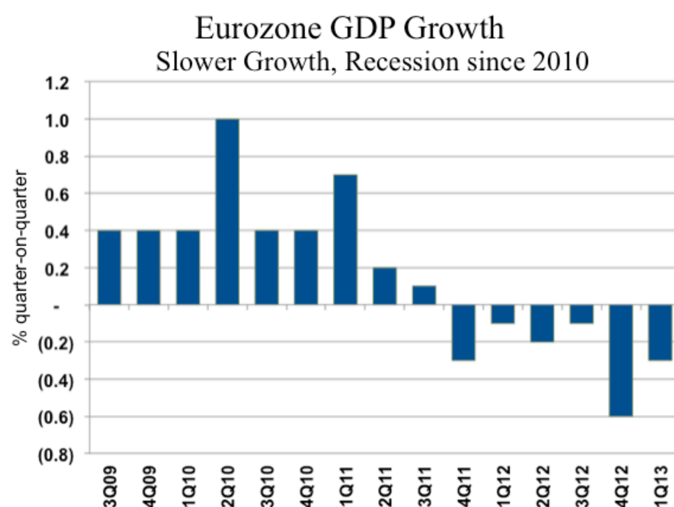
There are two other red flags in a seemingly benign transition for the region. The first is the deterioration in debt ratios since Greece's problems first surfaced in late-2009. As the chart shows, the region's debt-GDP ratio rose from 67% at the end of 2009 to 90.6% at the end of 2012, and further to 92.2% at the end of the first quarter of 2013. Greece's own ratio, 90% at year-end 2009, has since hit 161%. When I started my career in country risk analysis in the late 1970's, 50% was considered to be the safe maximum for the debt-GDP ratio. Now, few countries globally are below this threshold.

Sovereign risk rises, not only with the level of the debt-GDP ratio, but also with the rate of increase of the ratio. Here, notice that Spain's ratio, estimated at 85% at the end of 2012, more than doubled from 36% at the end of 2007. The speed with which the ratio has risen for the Eurozone as a whole, and for several countries within it, is an indication of the countries building excessive levels of debt.



Recession is lengthening

The “troika” - - the European Union, the ECB and the IMF - - which negotiates the austerity program with governments seeking bailouts, hopes that the measures will eventually lead to sustainable economic growth. This has yet to happen. Growth has generally been on a downward trend since the first Greece bailout in May 2010 imposed belt-tightening measures and they, in turn, served as the model for other countries to follow.



Despite repeatedly exceeding fiscal deficit limits set by the troika, worst affected countries such as Greece are, in fact, repeatedly tightening the fiscal belt through increases in public sector tariffs, layoffs of workers, and closures of government-owned companies. In turn, these measures by the public sector, and reduced consumption spending by workers with diminished earning power, are deepening the recession rather than provide an exit from the debt crisis.

The fall in the level of GDP, combined with a steadily increasing debt load, increases the debt-GDP ratio rather than lower it as the troika had originally intended. With no end to the difficulties in sight, *un callejón sin salida* as they would call it in Spain, is where the Eurozone finds itself today!

Countries Need Debt Reduction

Why is the Eurozone still in recession even as its debt ratios get worse? The ongoing bailout programs - - which essentially add to the debts of countries already unable to service existing obligations - - fail to recognize that these nations are experiencing a solvency problem, not a short-term loss of liquidity. To facilitate renewed growth, the countries need to have their debt levels and payments restructured to lower levels that can be serviced over time.

While a restructuring was attempted in the case of Greece in 2012, debt was left still too high, and is projected at around 120% of GDP even by 2020. Clearly, no growth is possible with such high debt levels. While debt reduction will impose “haircuts” on existing lenders, it would also bring in new investors attracted by better valuations and greater opportunities in a growing economy.

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