

Belt-Tightening Coming Back
Into Fashion in Europe

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The 2008-09 global financial crisis has left many economies, particularly the developed ones, in much weaker fiscal positions. The average gross government debt-to-GDP ratio for developed economies is projected to rise from almost 91% at end-2009 to 110% in 2015 –its highest level since the Second World War. As the global economy gradually recovers, revenues should stabilize and spending should decline as output and employment increase. However, this improvement will not be sufficient to restore fiscal balance in the developed world. Instead, policymakers will need to tighten their belts and adopt measures to reduce spending and raise taxes. Otherwise, investors will lose faith that developed countries will be able to repay their debts.

Structural Flaws in the Euro Zone

Investor trust has already been breached in Europe. Greece's fiscal indiscretions have been among the worst of the developed economies. Its starting debt-to-GDP ratio was already at 113% when the crisis began and it is poised to rise to 145% by 2015. The euro zone has been structurally flawed from the beginning with monetary policy controlled from the center, but fiscal policy controlled at the individual country level. The single currency actually enables members to run large deficits. A country with its own currency would see that currency decline and its interest rates rise if it sold large amounts of debt to global investors.

But because euro zone countries share a currency, there was no market mechanism to warn when a country's deficit was becoming unsustainable. Indeed, before the crisis, Greek bonds were regarded as a close substitute for the euro bonds of other member countries even though Greek government borrowing was well in excess of the 60% of GDP threshold set by the euro zone Growth and Stability Pact. Interest rates on Greek government debt only rose when investors began to fear default. At that point, the crisis spread to other countries in the euro zone running large budget deficits including Spain, Portugal and Ireland, despite the fact that their overall debt-to-GDP levels were much lower.

Why Hasn't The European Bailout Worked?

The European Union in cooperation with the International Monetary Fund announced a €750 billion (\$955 billion)

bailout plan to contain the sovereign debt crisis in Europe. This came on top of a €110 billion bailout package for Greece. The European Central Bank simultaneously unveiled a plan to purchase public and private debt to "ensure depth and liquidity in those market segments which are dysfunctional." If necessary, the US Federal Reserve has promised additional support in the form of US dollar swap lines to reduce strain in short-term dollar funding markets globally.

Unfortunately, the bailout was thin on details, and there was considerable uncertainty in terms of authorization, as much of the package is dependent on individual parliamentary approvals. Moreover, the bailout is just one side of the equation. It does nothing to address the structural flaws in the common currency. However, by reducing their need to go to the markets to refinance existing debt, it should buy some time for the more profligate countries in Europe to get their fiscal houses in order. Even with fiscal reform, some restructuring of Greek debt may be necessary down the road. Nevertheless, it was important that the Greek government adopt austerity measures before restructuring, otherwise there would be no incentive to change behavior.

Three Scenarios: Base Case, Optimistic, and Pessimistic

- I. Our base case scenario is for the euro zone to muddle through and the common currency to survive. We put the probability of such an outcome at roughly 80%. There will still be deep downturns in Greece, Spain, Portugal and Ireland due to severe fiscal tightening. These countries account for roughly 20% of euro zone GDP, and the IMF estimates their peak to trough decline in GDP will be roughly 6%. That implies a -1.2 percentage point impact on overall euro zone GDP growth. Core Europe, including Germany and France, should benefit from the 15% decline in the euro so far this year, which should be supportive of exports in these economies. Thus, while we have shaved our forecast for euro zone GDP growth from around 1.8% to roughly 0.6% for 2010, we continue to believe euro zone growth will remain positive for the year.
- II. Our optimistic scenario has a much lower probability at just 10% because it requires euro zone countries to sacrifice their fiscal sovereignty for the sake of the

currency union. This is the only scenario in which euro zone members address the structural flaws in the euro zone. It requires euro zone members to adopt a US-style system where countries pass constitutional amendments prohibiting borrowing for operating purposes similar to US states, which can issue debt to finance infrastructure but not salaries, services, transfer payments or other operating expenses. This scenario would give an immediate boost to investor confidence, driving down borrowing costs across the euro zone. Although growth would still weaken in 2010, the euro zone economic recovery would be much stronger in 2011. This could also be accompanied by a significant strengthening of the euro.

III. In our pessimistic scenario, the currency union breaks apart and there is a deeper and broader-based recession in Europe than in our base case scenario. We also put the probability of such an outcome at 10%. Reintroducing local currencies would result in severe dislocations across the euro zone leading to a flight to safety to the US dollar and other global currencies. There would also be the risk of a “beggar thy neighbor” mentality developing in which euro zone members employ protective tariffs and resort to competitive devaluations. Under such a scenario, a liquidity crisis could develop similar to the one in the fall of 2008 when LIBOR spreads blew out. The European banking system would come under tremendous strain and the likelihood of a euro zone depression would increase.

The Good, the Bad and the Ugly of Europe

The Three Strike Rule: Debt, Budget Deficit and Current Account Balance

	Debt to GDP	Budget Deficit to GDP	Current Account Balance to GDP	
Luxembourg	14.5%	-0.70%	5.74%	
Finland	44%	-2.20%	1.38%	
Austria	67%	-3.40%	1.40%	
Netherlands	61%	-5.30%	5.24%	
Germany	73%	-3.30%	4.49%	
France	78%	-7.50%	-1.45%	
Ireland	64%	-14.30%	-2.94%	
Belgium	97%	-6.00%	-0.27%	
Italy	116%	-5.30%	-3.37%	
Spain	53%	-11.20%	-5.06%	
Portugal	77%	-9.40%	-10.06%	
Greece	115%	-13.60%	-11.22%	

<p>Stable</p> <p>Neutral</p> <p>Unstable</p>	<p>Debt to GDP of 60% or less; Budget and Current Account Balance above -3% of GDP</p> <p>Debt to GDP above 60% but less than 90%; Budget and Current Account Balance below -3% of GDP but above -5% of GDP</p> <p>Debt to GDP above 90% Budget and Current Account Balance below -5% of GDP</p>
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* The above list does not include all 16 members of the common currency. Cyprus, Malta, Slovenia and Slovakia are excluded for this analysis.

Less Debt Is Better

Other countries in the developed world, including the United States, United Kingdom and Japan, would be wise to heed the lessons learned in Europe. Policymakers in these countries must be proactive in restoring fiscal balance or risk coming under more intense scrutiny from investors. These countries are fortunate in that they have independent monetary authorities and freely floating currencies that can alleviate some of the pain associated with fiscal adjustment. However, they also face large structural deficits due to the demands that aging populations will place on their public pension and healthcare systems.

By contrast, demographic trends remain much more favorable in emerging markets. Furthermore, the starting debt levels in these economies are a fraction of what they are in the developed world. The average gross government debt-to-GDP ratio in emerging markets is expected to decline from 38% to 34% by 2015. Faster growth rates, lower debt levels, and sounder financial systems suggest these countries will make further progress on convergence with the developed world. In fact, emerging markets' share of world GDP is expected to surpass that of the developed world by 2013.