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DECODING

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For more than two months sovereign debt in the eurozone and the United States has been the single issue determining investor sentiment, generating fresh weakness in equity markets. Until the end of July, neither the rather negative macro-economic signals nor US Q2 corporate results were able to distract the market's attention, which focused exclusively on potential "technical defaults" by Greece and the US. Furthermore, the juxtaposition of two such dissimilar borrowers, each considered driving forces behind investor fears over the past ten weeks, highlights the complexity of the situation and the need to understand the ramifications.

The sovereign debt crisis consists of three elements: (1) financial and technical: understanding the repercussions of a default on the settlement of swaps contracts (CDS) or the need for financial institutions holding public bonds to recapitalize; (2) macro-economic: consolidation plans needed to keep honouring repayments (given the lack of refinancing available in the market) are likely to prompt a very sharp drop in domestic demand, and banking recapitalizations run the risk of creating another credit crunch. (3) Lastly, political and institutional: the capacity of a sovereign issuer to return to the path of "sustainable" indebtedness is intrinsically linked to the quality of its governance, i.e. the capacity of its political organisations to take rapid, ambitious and credible decisions that are then put into practice in a resolute manner.

Clearly these three elements differ greatly from one side of the Atlantic to the other. As the first two have been copiously written about in market literature over the past few weeks, now is a good time to use this summer edition of *Decoding* to take a step back and **develop our analysis of the political context which, since the crisis broke out at the beginning of 2010, seems to be both at the heart of the matter and the key to its long-term resolution.** To do this, we will compare the US situation with that of the eurozone and by highlighting the differences in institutional organisation and the perceptions relating to these differences, explain a) the timing of the onset of these crises, b) the contagion spreading through the financial markets, and c) their degree of gravity and prospects for resolving them.

In light of current headlines, let's return to the panic that swept through the markets in the first days of August. Initially fuelled by renewed macroeconomic concerns, it was quickly fed by doubts over the credibility of decisions taken at the Brussels summit and the risk of contagion spreading to major European borrowers such as Italy and Spain. The situation eventually culminated in Standard & Poor's decision to downgrade US debt by one notch and maintain its negative outlook.

It is worth looking at a number of characteristics of the US and eurozone economies, not only in terms of institutional organisation, but also of the management of budgetary policies over the past fifteen years. A few of these characteristics are well known, but they help to clarify and explain some recent developments:

- **The United States has long been an "optimum" currency area.** Despite strong regional specializations and indirect tax rates that differ from state to state, US goods and services markets as well as labour seem largely integrated. Supported by a common language, uniform education system, relatively limited replacement income, and a highly liquid real estate market , at least until the subprime crisis, labour mobility is strong and encourages regional workforce movement whenever a specific shock - known to economists as an asymmetric shock - hits a region specialised in a given activity (such as automobiles in the north-east in the 1980s). Over the past century, the US has created powerful mutualisation instruments of financial and budgetary risks on a federal basis. The Federal Reserve System is the practical driving force of a single monetary policy covering all the Federal states and the dollar's guarantee of credibility (despite the US Treasury being notably responsible for setting exchange rate policy). The FDIC (Federal Deposit Insurance Corporation) helps limit the pitfalls associated with relatively fragmented and separate networks of commercial banks. Above all, the Federal budget is relatively large, representing almost 30% of US GDP in 2010. Financed by direct receipts, it has substantial flexibility to inject or tap national income and until now it has not been reined-in by "golden rules" (such as a ban on funding operational expenditure through borrowing) which put pressure on many American regional authorities.

- Compared with this US organisation, **institutional machinery in the eurozone clearly appears very different, reflecting the lack of political integration in European monetary union.** Let's remember that the single currency project at the end of the 1980s was languishing in the planning stage, then was put at the very top of the agenda for the Maastricht Treaty (1991), mainly by France, in return for accepting German reunification. Speed was essential if an historic opportunity were not to be missed, and the warnings given by many economists on the less-than-perfect nature of the European monetary zone and its need at least coordinated adjustment instruments, were rapidly brushed aside. Advocates of the single currency said that monetary union would accelerate the integration of goods and services markets, so reducing the likelihood of asymmetric shocks. **Lacking short-term plans to create a European "economic government" with intervention powers across the EU, the gamble was to replace it in the interim with a series of common regulations.** That was based on the understanding that the de facto solidity created by the single currency would force member states to move toward a "supranational" political authority. Until the creation of the EU Solidarity Fund, there were no plans for any budgetary mutualisation instruments, and even less so for management of Europe's economic cycle. Let's not forget that the community budget, representing some 1% of the EU's GDP, is not generated from the income of economic activity but on the "fixed" contributions of member states. Furthermore, its expenditure (mainly on the Common Agricultural Policy) is programmatic in nature and only generates cash flows at the end of very long periods.
- Formulating and running budgetary policies, and more broadly the policy mix, is another key factor that distinguishes the United States from the eurozone. **Since the New Deal, the US has been following a genuinely contra-cyclical policy on an almost systematic basis.** By "genuinely" contra-cyclical we mean a policy that provides an injection of national income through the Federal budget by increasing expenditure or cutting taxes in a recessionary phase. In return, it is an indispensable corollary to guarantee the sustainability of this strategy in the long term as it represents a drain on GDP in a strong growth phase by increasing taxes or cutting structural expenditure. To illustrate, the budget deficit which reached almost 5% of GDP at the end of the 1990-1991 recession had turned into a budget surplus of 3% of GDP by 1999. This trajectory was thanks not only to the deficit reduction in surplus income generated by an extremely strong phase of economic expansion between 1996 and 2000, but also by significant reductions at a structural expenditure level by the Clinton administration from 1992 onwards. The same trend began to emerge in the decade starting in 2000: the fiscal balance, which had declined to a 3.5% GDP deficit in the 2000-2001 recession picked up to -1% of GDP in 2006. Compared with past fiscal years, this trend was nevertheless limited, not only because the expansionary phase was relatively short-lived (mid 2003-beginning 2007), **but above all due to tax cuts and military spending by the Bush administration which prevented a positive turn-around in the structural balance, giving an improvement of only 2% of GDP between 2003 and 2006).**
- **The budgetary policy culture in Europe is quite different across European nations.** While the German model is traditionally skeptical about using policy to smooth economic phases, "structurally" sound finances aim to offer a stable and credible framework over the long term, allowing economic agents to make decisions on consumer spending, savings and investment with as much certainty as possible over future fiscal policy. In the eurozone's major "Latin" countries (with the notable exception of Spain for the past 30 years), the concept of using the budget was radically different. Long employed in an economic Keynesian "stop-go" framework, public finances in these countries have adopted a systematic "spending" bias since the oil crises of the 1970s. Not only was public spending used to sustain activity in phases of slowdown and recession, but also played a part in phases of expansion as supplementary revenue from the cycle was allocated as a priority to new structural expenditure, adding another deficit factor to the subsequent slowdown. **In other words, during prosperous economic cycles these strategies were unable to rebuild the margins needed to**

deal with the next shock, so undermining their long-term credibility. During this period, the only episode of large-scale budgetary consolidation across several member states fittingly coincided with a necessary "convergence" period between 1995 and 1997 to meet a 3% public deficit criterion. Once the formal decision on qualification for monetary union had been taken, efforts were very quickly relaxed and deficits at best stabilized despite an extremely favourable economic background. **The convergence of long-term interest rates with those of "the safest" issuer, i.e. Germany, offered an additional anesthetizing factor that encouraged continued spending that, over the long term, was not funded.** In Spain, things were slightly different: from the mid 1980s when it joined the European Community, the young Spanish democracy introduced a very ambitious program of economic reforms over more than fifteen years, accompanied by massive restructuring of its public finances (and a budget surplus of 2% of GDP in 2007). However, this program produced an economy that became extremely specialised in particular sectors, particularly construction, making it highly vulnerable to a genuine "asymmetric shock." That shock finally occurred with the credit crunch sparked by the subprime crisis and dramatic contractions in Spanish construction and real estate markets. Faced with this, the public budget became the only available stabilisation instrument, at the expense of a deficit that rose to 11% of GDP in 2009.

- Although played down in official speeches, these various risks (the moral hazard generated by artificially low interest rates or the appearance of an asymmetric shock) had been identified prior to monetary union. **But the solutions that have ultimately been used to deal with the problem, a long way from the US's integrated institutional framework, have been highly inefficient in every respect.** In 1995, Germany's Finance Minister Theo Waigel proposed supplementing the Maastricht Treaty with a "stability and growth pact" based on relatively basic principles under which the 3% deficit and 60% public debt criteria would have to be met at all times by every member of the monetary union. Any country in breach of these criteria would incur systematic and automatic GDP-proportionate penalties. This idea had the merit of simplicity and transparency, but was not without drawbacks. The German way of thinking would have placed considerable restrictions on the ability to use fiscal policy to absorb major macro-economic shocks without running very major surpluses at the top of the economic cycle, a less than optimal situation. Fines would have further complicated the financial position of states that were already in trouble and their automatic nature removed any hope of rapid progress towards an embryonic economic government. In other words, convergence was favoured over coordination (which may in some cases implies running differing fiscal policies). Germany's partners than amended the project, resulting in an extremely bureaucratic procedure whereby failure by a member state to respect multi-year commitments would, once the commission had conducted an analysis, could have led to a warning followed by sanctions decided by the members of the eurozone. **With hindsight, the consequences were fairly predictable: lots of breaches and no sanctions were ever applied. Similarly, until 2010 markets scarcely distinguished between borrowers.**

This extended history helps to explain the following paradox: while the structure of revenues and public spending makes the US economy less sensitive overall to shifts in the fiscal balance than is the case in many European states, the lack of any proper coordination mechanism within the eurozone has made budgetary policy ineffective at the level where it was supposed to be most pertinent – monetary union. Regardless of the starting point for deficits and the level of debt, which today are pretty similar on both sides of the Atlantic, both the credibility of the institutional structure and the different track records in coping with large deficits were such that the US and the eurozone did not set out on an equal footing. This explains the differences we have seen in 1) the timing of the tensions that have emerged, first in the eurozone and then in the US 2) the trend spilling over to financial assets and 3) the gravity of the two situations and possible ways out:

- **As for the timing of the appearance of the tensions, both cases started with signs of market mistrust, albeit different in nature and perspective.** The sovereign debt crisis in the eurozone was initially triggered in January 2010 by an announcement from the new Greek government that the public accounts provided by its predecessor had been inaccurate. The crisis of trust grew worse as it rapidly became apparent that the Europeans lacked the tools to deal with the situation. Respite only came in May 2010 when the European Council positively surprised markets with a rapid and robust decision to put in place refinancing arrangements and a guarantee that appeared to be commensurate with the situation. Re-launched one year later when it had become apparent that despite the accomplishments, initial results of the Greek fiscal adjustment plan were not sufficient for the EU, this left Greece dependant on the market, which by now was prohibitively expensive. The slow and feeble response by the euro zone fanned fears that it was quite incapable of dealing with any spread of tensions to a major issuer like Italy or Spain. **In the US**, fears of a "technical" default were also triggered by an issue of political trust, but of a wholly different nature. The uncertainty arose from the unusual turn taken by the now regular renegotiation of the Federal debt ceiling. In our view, the obstacles that emerged during the discussions between Congress and the administration lie in the unusual splintering in the Republican majority, which is seething with tendencies pursuing different and even contradictory goals. Regrettable as this may be, the position is not "structural" and simply reflects a political balancing act that could change by the next elections in 2012. We do not think it is evidence of permanent damage to the US's ability to get its debt under control in the long term.

- **The way these tensions spread to financial assets was quite different on the two sides of the Atlantic.** In Europe, the fiscal problems experienced by Greece and other peripheral countries in the eurozone first led to a rise in long rates for the issuers concerned as their risk premiums shot up, along with the cost of credit default swaps on their bonds. This initial shock translated directly into equity markets through the stock prices of banks, which hold the affected bonds and in some cases had sold credit default swaps on them. Spreads between long rates within the eurozone ballooned (with the OAT/Bund spread moving to 80 basis points, a level last seen in 1994 before monetary union) and the euro fell sharply, especially against haven currencies such as the Swiss franc. In the US, tensions from the fiscal debate immediately hit cyclical stocks on the idea that budgetary paralysis would take away additional public-sector support just as the economy was slowing and doubts emerged about QE2's true impact on growth (see below). **However, long-term rates in the US have hardly moved (and even saw a major rally in the second half of July, just at the nadir of the stalemate in negotiations) while the dollar has been stable overall. This indicates that investors do not see the crisis as a debt crisis or as an immediate threat to the US currency's reserve status.**
- **These trends emphasize both the different nature and the possible solutions in the US and the euro zone.** There is no dispute that the two regions are suffering from excessive deficits and public borrowing. We nevertheless continue to believe that the US has 1) the institutional means, 2) the credibility in terms of past track record and 3) the opportunity in the coming years (with the planned reduction in military spending, even though this will be partly offset by rising welfare spending) to reduce its deficits. At this stage there is no need to regard the dysfunctional divisions in the Republican party as a permanent vulnerability. In contrast, the eurozone has from its very inception lacked the mechanisms to deal with a true crisis of solvency of the sort facing Greece, Ireland and probably also Portugal, not to mention the less-justified speculative attacks such as those now hitting Italy (rare among developed economies in having a primary budget surplus) and Spain, whose fiscal position is wholly due to the sharp shock the economy has suffered. Provided the accompanying message is not lost in the noise, solutions of the sort announced by the ECB on 7 August which consist of buying up bonds of the countries under attack are a first line of defense that are likely to calm markets in the short term. Subsequently,, even the introduction of shared fiscal instruments such as an enlarged European Financial Stabilisation Fund or the issue of eurobonds will rapidly reach its limits if the crisis remains widespread. Not even a guarantee from Germany, the only lender of last resort, will be adequate. **Only a thorough and rapid institutional revolution will be able to definitively reverse the negative trend in the eurozone, and today, that looks a distant prospect.**

This issue would not be complete without analysing the storm that has shaken markets since the end of July, pushing them down nearly 15% in Europe and 10% in the US and Asia, accompanied by a spike in short-term volatility. The prime cause behind this has been poor macro-economic statistics on the US economy, both backward-looking and covering the present. US GDP figures in the first quarter of 2011 were revised down significantly and suggest that growth was virtually zero at the start of the year, fuelling doubts as to the true efficacy of the Fed's QE2 program. The ISM that came out on 1 August was nearing the 50 level and revived the debate about a possible double dip with the US economy falling back into recession. Nervousness quickly spread that the European debt crisis could spill over to borrowers like Italy and Spain, which are large enough to blow a hole in the eurozone. Speculation that the US might be downgraded, as finally announced by S&P August 5, amplified this trend, even though at this stage the reaction of the dollar and the US long bond appear to suggest investors either do not fully share the rating agency's diagnosis, or else are simply unable to move out of US debt.

Our comments on these events are as follows:

- The market movements seen in the first week of August were very sharp, and accompanied towards the end of the week by volumes not seen since 2008. **Our various traditional indicators suggest that markets are capitulating.**
- **There is scope for a technical rebound, but the triggers for a lasting recovery look limited:**
  - The macro situation is not promising. Leading indicators are not yet pointing to a return to recession, and there are even reasons to hope things may brighten up (US auto sales were fairly positive in July, the labour market has been relatively resilient, the Japanese shock is fading and the gasoline price is coming

back down); but even under the most favourable scenario this will take time and the economic news flow in August will likely remain negative.

- In recent years policymakers have given the impression of losing touch. They will likely try to regain it in the coming days. Both the BoJ and the ECB have started a new round of quantitative easing, the Bank of England looks set to do so and the Fed statement due this week will probably give more information on how long it can keep its balance sheet at the current size.
- These initiatives could be swept aside, and may even be seen as uncoordinated if in the meantime other central banks such as the BoJ and the SNB fight to stem the appreciation of their currencies, which is an undisputed mechanism for adjustment. From this perspective, the communiqués from the G7 and the G20 stating their willingness to take all necessary measures to ensure the liquidity and stability of markets are mainly interesting in terms of coordination. Without more detail, and thus credibility, there is a risk they will be insufficient at this stage.

- **Can equity markets fall further? Absolutely, if additional risks start to appear:**
- If July retail sales and, especially, manufacturing surveys, disappoint and indicate a fall in new orders, this would boost the risk of recession.
- If the status of the dollar as a reserve currency comes under attack in the short term, with the dollar falling and the long bond rising, the shock could have a major impact on the valuation of all risk assets. What will count in this regard is not so much S&P's announcement as the attitude of those who hold large currency reserves, primarily China and Japan. We view this risk as low in the short term.
- If the eurozone debt crisis spreads to big issuers like Italy, Spain and possibly even France, and shows signs of taking root there, the impact on equity markets through bank stocks will be even greater. The interbank market would likely freeze as it did in 2008.

The worst-case scenario is never certain but events are unfolding in such a way that the elements characterizing these three "fronts" need to be analysed in real time to identify the measures needed to protect portfolios.

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