

Europe's sovereign debt – a king size headache?



Some think that sovereign debt – in simple terms, borrowings by a national government against securities issued by the Treasury of the same government – can be the world's riskiest form of lending.

The reason? There is no security or collateral for these loans beyond the financial stability of the borrower, expressed as their international credit rating. If Country A were to default, for example, then the lenders (Country B; Bank C), can't lay claim to a city or a few suburbs to get their money back; they just take their losses. But Country A will struggle for years to get another loan at reasonable interest rates.

Some smaller economies in Europe, notably Portugal, Ireland and Greece, have been unable to service their sovereign debt. Greece has been targeted as the worst offender, having gone to the brink twice since January 2010, before being rescued by French and German financing each time. But problems remain and a third bailout package may be needed. While this drama unfolds, there are fears that Italy and Portugal are on the same path.¹

Australia has been largely unaffected by this European angst to date. Our government has no exposure to European sovereign debt and our commercial banks, which at one stage were relying heavily on wholesale borrowing from European banks to finance their domestic lending, are no longer widely exposed to a deteriorating European lending climate. So why did treasurer Wayne Swan warn us that the Greek financial crisis could result in global turmoil which could involve Australia?

A real threat?

The reason is that, in a worst-case scenario, the European sovereign debt crisis could escalate and spread across the Atlantic to the USA. At the moment, American banks have approximately \$41 billion of direct exposure

to Greek debt, plus problems with their own national debt levels.² This combination of US and European uncertainty could ultimately lead to in bank failures reminiscent of the Lehmans collapse which, some argue, triggered the Global Financial Crisis.³

The only way for the weaker members of the European community to remain solvent and honour their obligations to repay their sovereign debt is to obtain further financial aid from the stronger members of the group. The problem is that both France and Germany have already committed billions of Euro to Greece, and French and German taxpayers are objecting to any further aid. Plus, the interest rates on new emergency loans will be so high it's feared Greece will never be able to repay the debt.⁴ France and Germany, with the European Central Bank, are urgently seeking a viable solution. A recent proposal is that Greece be allowed to default on part of its debt, resulting in losses to the bond holders, but a smaller and more manageable national debt.⁵

Building a solution

Though some lenders might have to take a slight 'haircut' after a partial default, it might be a better outcome for the European banks than the far more drastic alternative. This 'alternative' is simply that Greece defaults on its sovereign debt. This would mean all its debts would be written off or discounted, which did happen in Argentina in 2001.⁶ This proposal may have some appeal to many angry Greek citizens who took to the streets in protest against the austerity measures announced to qualify for the last European handout.

Not surprisingly, a default on this scale has far-reaching implications. While Argentina ended its sovereign debt crisis by defaulting, to this day it can't borrow money overseas.⁷ On the flip side, their economy took just three years to recover.

A further complication for Europe is that a cashed-up China is standing by to pick up some pieces. China recently acquired Greece's largest container terminal in Piraeus at a bargain price, gaining an important entree into the European shipping market. It is now looking for more bargains.⁸

Within Europe, France and Germany have the strongest incentive to continue supporting the weaker economies in the euro zone – particularly as the amounts of money involved may look huge but are not that large in relative terms.⁹ Greece represents only 3 per cent of Europe's gross domestic product (approximately \$311 billion vs. \$16 trillion) and currently owes France the equivalent of 34 per cent of its GDP and Germany 21 per cent.¹⁰ Given this relativity, France and Germany will hopefully once again pull a rabbit out of the euro hat to protect the currency and the European trading zone.

If that happens, we can echo federal treasurer Swan's statement of June 2011: "There's no doubt there are great challenges in Europe and there's no doubt there were great challenges in Europe this time last year ... but fortunately we're in the right part of the world at the right time. The Asia-Pacific is relatively strong, our economy is strong."¹¹

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9 NY Times, April 5 2010 – As Greek Bond Rates Soar, Bankruptcy Looms, <http://dealbook.nytimes.com/2010/04/09/as-greek-bond-rates-soar-bankruptcy-looms/>

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