

Global debt: All at sea



Overview: The financial crisis has permanently changed our world

Debt dynamics will define the next decade for economies and markets

Debt is everywhere. Leverage has exploded across most major economies in the last several decades – in many cases exponentially. Predictions of gloom have resurfaced continually but economies have more often than not surprised with their ability to overcome the odds and stretch the cycle one more time. Large, developed economies have proven to be surprisingly resilient and flexible. However, the “Great Recession” of 2008-2009 appears to have raised the bar to an unprecedented height. Have economies finally reached the limits of leverage? If so, what happens now?

The interplay between debt and growth, default risk, bond yields, equity markets and economic policy is complex and poorly understood. The list of questions is long, but critical to understanding the behaviour of today’s markets.

- Why is Greece imploding whilst countries such as the US and Japan behave irresponsibly and yet possess a “safe harbour” status?
- How can Japan, which on many counts is in a weaker fiscal position than any other developed country, borrow at rates of less than 1% and experience so little volatility?
- Can the US retain access to foreign capital? What does the recent downgrade mean for markets?
- Are developed, indebted economies going in the direction of Japan, wherein growth and asset returns remain low for a long period?
- Will debt problems spell the demise of the eurozone? If so, when?
- Can Italy and Spain sidestep the contagion from the weakest members of the eurozone?
- Will austerity work for highly indebted countries such as the UK? Or is it a false promise that only precipitates more pain?

These questions are important to the growth trajectory of each nation and the world as a whole. But they need to be set within the context of the diverse factors that have contributed to the unsustainable outcomes in each region. These differences are fundamentally related to the policy options currently available to shape a more sustainable future.

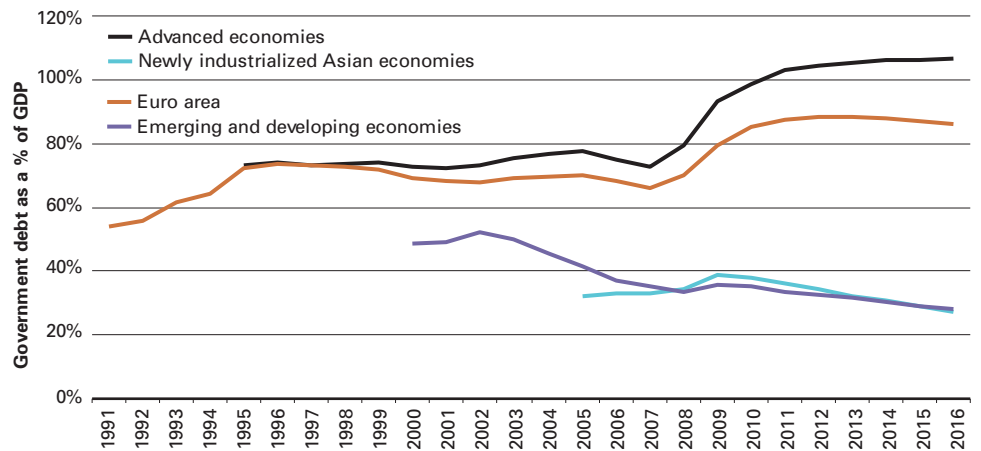
To adopt a phrase often applied by the Chinese Premier Wen Jiabao to his country, the world economy is “unsteady, unbalanced, uncoordinated and unsustainable.”¹

The state we're in – how did the developed world end up in such dire straits?

The growth of advanced economy debt exploded after the last crisis

Since the turn of the millennium, the escalating deficits of most developed economies have contributed to rising government debt to GDP ratios. Meanwhile, emerging markets and newly industrialised Asian economies are characterised by falling government debt ratios. These different patterns reflect a continuing divide in rates of economic growth between developed and developing economies.

Rising government debt has outstripped GDP growth in developed economies

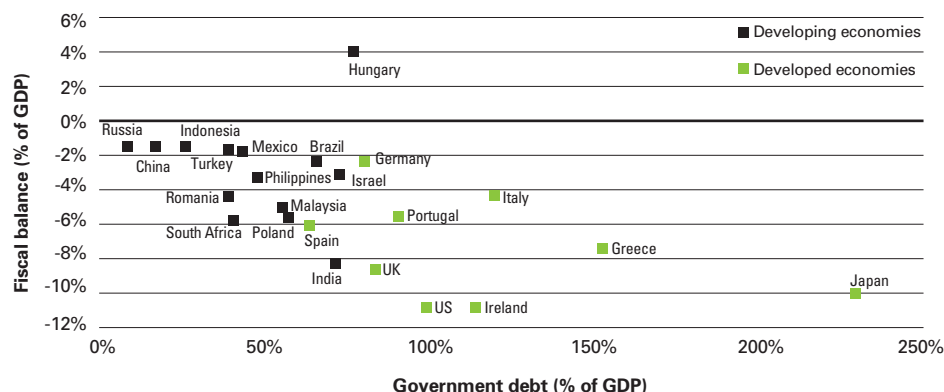


Source: IMF database, April 2011.
 Note: Actual data to 2009, IMF estimates 2010-2016.

While western economies have boosted growth through fiscal recklessness, emerging markets have been the shining stars of the global recovery story. The strong debt position of many developing countries reflects the comparative ease with which these economies have been able to navigate the recession. Emerging economies entered the crisis in a sounder position than many developed countries, having experienced sustained favourable economic performance and institutional changes that contributed to deficit and debt reduction from the early 2000s. Emerging economies are well positioned to take advantage of the changing global economic landscape.

Developed markets, on the other hand, have lost control of their own destiny. Debt dynamics will continue to challenge developed countries and shape international financial markets for at least the next decade. The chart below shows deficits (fiscal balances) and debt stock as a percentage of GDP. Some countries, notably those depicted in the lower right quadrant, are in particularly untenable fiscal positions. Not only are they already over-leveraged, they continue to have heavy borrowing needs and are consequently leveraging even further.

Advanced economy fiscal and debt positions are unsustainable



Source: Threadneedle Investments, IMF database, April 2011, Haver Analytics.

Follow the bouncing ball – how rotating leverage has perpetuated the global cycle

There is an element of circularity to the contrasting positions of developed and developing nations, with the result that no convergence of debt ratios is expected before 2016.

Ireland, Portugal and Spain will continue to have mounting debt problems over the next five years, alongside the US and Japan.

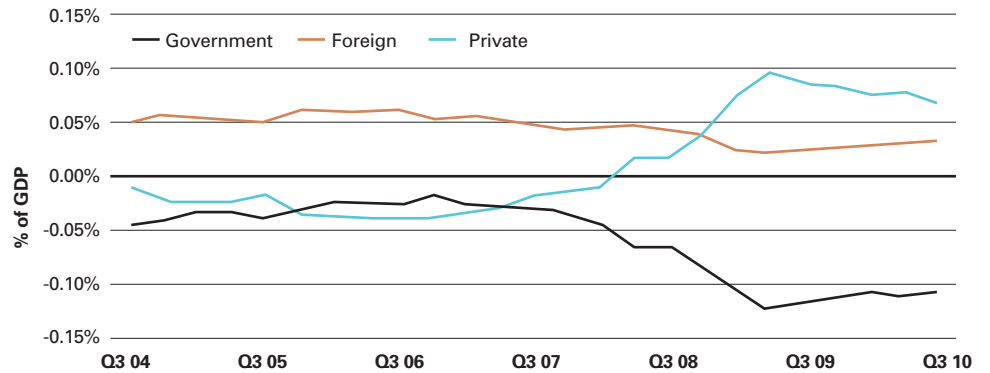
The circularity is no accident. In a global economy, those that borrow – the “dis-savers” – must be exactly offset by savers willing to finance these deficits. In a domestic economy, this was traditionally expressed via three groups – governments, corporations and consumers. Much of the economic history of the last century can be explained by a cycle of “rotating leverage” in which one of these groups finances a borrowing binge by another. In 2002, for example, we witnessed a global crisis of corporate leverage. Defaults spiked as excessive leverage left corporations dangerously exposed to an economic slowdown. The crisis was short-lived but painful. Consumers quickly stepped in to fill the void left by de-leveraging corporations, but this merely paved the way to the next crisis. Consumer “dis-saving”, primarily through excessive mortgage borrowing, left them dangerously exposed to the next crisis, which arrived in 2007-2008.

Fast forward to today’s calamity and it is little surprise that the government sector was the only one of the three segments large enough to bail out the other “dis-savers”. Massive government deficits were the answer, as this was the only mechanism to effectively get the economy growing again while still allowing the over-levered private sector to simultaneously repair their balance sheets.

The above example is a simplification. In fact, most advanced economies have found an even more creative way to finance their “dis-saving” over the last two decades. By importing capital from savers outside their own country, it became possible for both the private and public sectors of a developed economy to boost leverage simultaneously. With emerging economies rich in savings, a virtuous circle was born.

The chart below illustrates how this cycle has played out in the United States. Both the private and government segments were running deficits prior to the onset of the crisis, financed entirely by foreigners. The crisis changed everything. Governments had no choice but to pick up the baton from the private sector, leveraging up massively to support a deleveraging private sector.

US flow of funds by sector – governments to the rescue!



Source: Cross Border Finance.

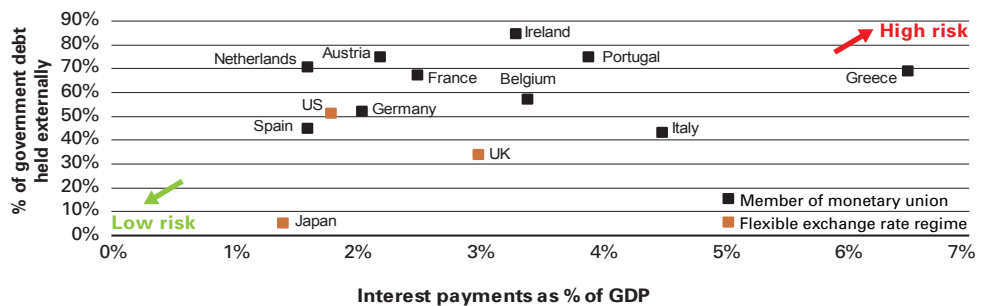
The challenge today is that traditional responses are no longer feasible. The typical G7 response to recession has been to lower rates by 0.6 to 0.7% and increase government consumption by more than one percentage point of GDP. With rates close to zero and government largesse under attack, neither policy action will happen. It appears that it will be up to corporations to move the economy forward this time. As owners of the only prudent balance sheets in the economy, it is essential that corporations gain the confidence to spend and ultimately expand their workforces.

Debt overload: is the problem insurmountable?

High debt loads and large primary budget deficits are key contributors to credit and default risk. But they are only part of the story. Some countries have exceeded the tipping point and defaulted when debt to GDP ratios were only 60%. Others, such as Japan, are above 200% with no outward ill effects. There must be more to the debt problem than these metrics alone.

The chart below highlights three additional credit metrics – interest payments as a percentage of GDP, the percentage of debt held externally, and the nature of the exchange rate regime. Statistically, each of these measures is more important than deficits and debt to GDP in explaining sovereign stress and default. The first is a direct measure of whether a country can meet its obligations. A high proportion of foreign held debt raises the prospect of being shut out from markets. And the ability to deflate a currency is fundamental to mitigating default risk. An inability to debase one’s currency simply means that a similar adjustment must be made to real living standards, an extraordinarily painful process fraught with risks.

Fiscal concerns – critical for some, overblown for others: Greece is likely to restructure; Italy and Spain should survive



Source: Bank Credit Analyst.

These credit metrics can be combined to produce a simple model of underlying credit risk. Some countries, as noted in the case of Japan, score miserably on some measures but quite well on others. This is important. The ultimate remedy for excessive debt loads is time and growth. Low default risk affords an economy the luxury of time. High default risk highlights vulnerability to either negative macro forces or a policy mistake, and may make the debt burden insurmountable in the event of a shock.

Aggregating these factors highlights some anomalies. Greece is an outlier, scoring miserably on virtually every metric. Default or restructuring appears inevitable. Ireland and Portugal are in considerably better shape than Greece, but the lack of a free floating currency portends a long period of sub-trend economic performance if global growth remains supportive, but likely debt restructuring if it does not. Italy and Spain are both in an economic mess, but default risk appears overblown and reflects the anticipation of policy mistakes, which may not happen.

France is still far away from any default trigger. And suggestions that the US and UK are on the cusp of a tipping point seem wildly premature. While it is true that the magnitude of the problems is enormous, jumping to a fatalistic conclusion that nothing can be done about them is misguided.

Growth remains the preferred means for moving out of a debt crisis and is certainly the only painless way to remedy the problem. Leverage is a simple concept. If one earns more on assets than the cost of borrowing, it pays to employ leverage. Earn less, and it spells trouble.

It is immediately apparent why the "stock of debt" of a country seldom explains when markets are likely to riot and countries likely to default. The key is actually growth. If growth is healthy and stable, an economy can shoulder a very large debt burden. As growth falls below that of the cost of borrowing, however, the downward cycle can quickly become self-reinforcing.

Today's fundamental problem is the lack of growth in the developed world. Debt is much like an option. If growth is robust, default risk remains subdued. Even small downward adjustments to growth prove immaterial if overall conditions remain supportive. However, if nominal growth moves below the cost of borrowing, the damage is often severe. Efficient markets must price in this risk as growth approaches the danger zone, which is typically well before growth actually turns negative.

This is partly why markets are unstable today. Growth rates are dangerously close to stall speed and policy options are limited. It is not a coincidence that the last three tumultuous periods for peripheral Europe have accompanied growth scares. The role of policymakers has always been key to the market adjustment process. Both monetary and fiscal policymakers have typically reacted to slow growth with a strong dose of stimulus. This has not only helped growth but also confidence.

Policymakers have lost their way and their options

Policymakers would have been wise to remember the final component of option valuation – volatility – and applied it to their own debt dilemmas. Volatility reflects the range of potential outcomes. Minimising this “volatility” by limiting the downside risk of various policy outcomes has always been at the heart of sound policy. Policymakers appear to be forgetting this lesson. The debt debacle in the US and the inaction in the eurozone did nothing to rule out any scenario, no matter how catastrophic. Outcomes, such as a US default and a breakup of the eurozone, have become part of our lexicon. Policymakers are to blame.

Policy in the US has been reckless. In the recent debt ceiling debates, a lack of reason, leadership and economic knowledge were all put on public display. The end result is a package that stipulates only \$21 billion of cuts before the end of 2012, an insignificant portion of the \$1.7 trillion total budget. The European Central Bank (ECB) has behaved even less credibly. At best, ECB policy has been misguided; at worst, it has been inept, perpetuating a crisis that may now be irreversible for the weaker members. In the midst of crisis, the ECB has:

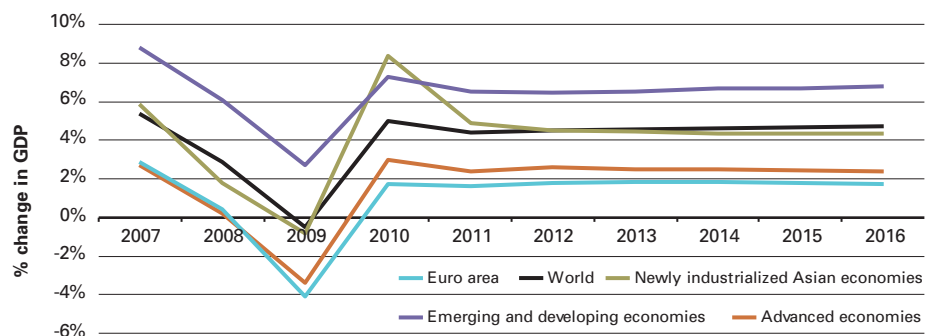
1. Sharply curtailed purchases of eurozone bonds before the markets forced its hand.
2. Ruled out quantitative easing.
3. Created confusion as to whether it would accept Greek bonds as collateral.
4. Raised interest rates – twice.

In a crisis period where better growth is an essential part of the remedy, the ECB has instead acted to suppress growth and transparency. No one will doubt the ECB’s inflation fighting credentials anytime soon, but they will doubt its logic. If the eurozone is to survive, the ECB will ultimately need to retreat from these stands.

Financial markets – adapting to the new world of debt

If growth is the panacea, current trends are very discouraging. Advanced economies remain in the doldrums, and would be in even worse shape if not for the contribution of emerging markets. The IMF is forecasting an average emerging market growth rate of 6.5% in 2011 and 2012, compared with just 2.4% in 2011 and 2.6% in 2012 in the advanced economies. The eurozone is dragging down the average growth rate of advanced economies, as can be seen in the chart below.²

Advanced economies are set for an ongoing period of slow growth in GDP



Source: IMF database, April 2011.

Note: Actual data to 2009, IMF estimates 2010-2016.

GDP: What's debt got to do with it?

Countries with debt above 90% of GDP grow by an average of 1.3 percentage points per year slower than less debt-ridden countries, according to two US economists, Reinhart and Rogoff.³ This scenario applies to most economies, undermining their growth trajectories and exacerbating the imbalance between the developed and developing worlds. It has given rise to a “two-speed world” – a term reflecting the differing growth prospects of developed and developing markets.

Debt can strangle economic growth. As debt becomes excessive, the value of the local currency may fall, leading investors to demand higher interest rates if they anticipate further currency depreciation. If government borrowing pushes interest rates higher, domestic growth will slow – “crowding out” of the private sector. Persistently high levels of government debt may also necessitate higher interest rates to compensate for increased risk of default.⁴ Rising interest rate payments stifle the public budget, consuming money that could otherwise be spent more productively. One US study showed that, without reform, “by 2027 interest on the US federal government’s debt will be the largest item in the budget – far more than the amounts spent on education, infrastructure and research and development.”⁵

Population dynamics, too, are not conducive to supporting ongoing high levels of national debt. With the ageing population that typifies most advanced economies, there is, *ceteris paribus*, a declining tax take and a rising social support requirement.

Developed economies are ensnared in their own trap. Debt levels are too high. The one painless way out of the debt mess is through growth. Growth, coupled with fiscal responsibility, is the preferred approach to sustainability. But difficulties remain:

1. The very debt that once spurred growth can also act as a material drag on growth.
2. Fiscal tightening is a recipe for still weaker GDP.

It is not easy to escape the conclusion that growth will be weak for several years to come.

Policy responses to excessive debt – “polite” ways to default

Conventional thinking dictates that the response to economic woes must be the introduction of an austerity programme – “belt-tightening”. This is a myth. There is no “one size fits all” solution to the world’s economic problems. The very different circumstances of indebted countries call for different policy responses. Not every option is open to every country, and policy mistakes will dictate that many countries venture down the wrong path. Understanding these options will provide the blueprint for understanding appropriate measures in the years to come.

The following table highlights some of the many options for escaping the debt trap. While the best strategy is growth, this table assumes that the traditional methods of boosting growth have been exhausted, which indeed captures the plight of much of the developed world today.

Markets will be shaped by the policy approaches to unsustainable debt trajectories

Policy response options	Overall effect of policy response	Impact on sovereign bond prices	Impact on risky* asset prices
Austerity programmes	May work, but unproven in economies with highly levered private and financial sectors	Higher	Lower
Borrow more to boost growth	Does not work in the medium- to long-term, but can appear to work in the short term via stimulus	Lower	Higher in early stages, but lower as more prudence is required
Default / restructure debt	Does not work, but might be the only option for some	Lower	Lower
Reneg on promises to local constituencies (pensions, social support programmes)	Yes, likely to work but perhaps at the expense of political upheaval	Higher	Higher
Re-finance debt through higher savings	Likely to work but at the expense of slower growth	Higher	Lower
Print money and devalue currency	Yes it works, provided inflation is kept under control	Uncertain	Higher (in local currency)
Inflate your way out of the problem	No, does not work, unless one can continuously surprise the markets	Lower	Lower

Source: Threadneedle Investments, 2011.

Note: * Risky assets include equities, credit spreads, etc.

Many countries will rely primarily on one of two of these approaches. Others will utilise multiple strategies, picking and choosing based on what is politically acceptable and what the markets will bear. The difficulty for markets is that some of these outcomes are good for risky assets, yet others can have a profoundly negative impact. A simple notion that “high debt is bad for economies and markets” is misguided.

Which countries will pursue the various options outlined above? The next section of this report takes a closer look at the debt troubles plaguing the US, Japan, Greece, Italy and Spain, and the UK – the nations at the heart of the debt dilemma.

The outlook for global debt trajectories – some comparative case studies

United States

The US – how \$1 trillion deficits became the norm

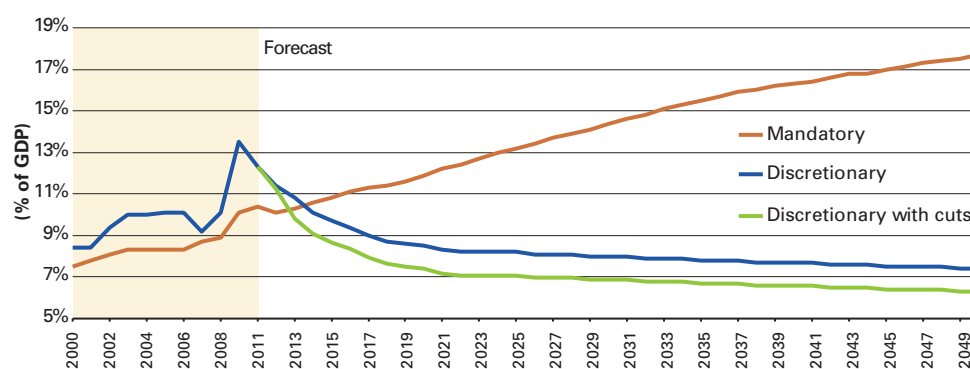
In common with other developed economies, US debt grew at an increasing rate from the year 2000 and by May 2011, it had reached the debt ceiling at \$14.3 trillion. For the 2011 financial year, the budget deficit is forecast to be \$1.3 trillion, more than the \$1.17 trillion deficit for 2010, but down from the \$1.7 trillion deficit for the 2009 financial year. Although spending injections have mitigated the effects of recession, the level of debt in the US has been growing at an alarming rate for some time now. S&P expressed concerns about the country's unclear path to addressing its "very large budget deficits and rising government indebtedness".⁶ S&P followed through on their threat, downgrading the US sovereign rating from AAA to AA+ on 5 August. The debt ceiling debate had culminated in a deal insufficient to reverse the nation's deficit. More importantly, the agency cited their lack of confidence in the "effectiveness, stability and predictability of US policymaking".

The rating downgrade is a response, not a driver

The US debt debacle is a serious issue, but the country has a significant degree of flexibility. Looking forward, it makes sense to divide the analysis into short-term and long-term effects. The short-term outlook for the treasury market will be largely unaffected by the S&P downgrade. Rating agencies do not determine the credit quality of a borrower, they merely opine on it, and the credit quality of the US is no different today than it was several weeks ago. Treasury yields will continue to be driven by interest rate fundamentals – such as inflation and growth – and not by credit quality concerns. A recessionary environment should generate lower interest rates, just as it always has.

The longer-term outlook is more tenuous. The budget outlook for the US is simply not sustainable. The chart below highlights the projected path of debt to GDP under several scenarios. Any discussion about the details underlying these calculations is somewhat irrelevant. The markets will simply not allow these scenarios to be played out. Opinions that the current trajectory of fiscal imbalances will ultimately lead to default are simple scare-mongering. While correct in fact, the prospect of default is serious enough to fundamentally alter the path. The relevant question is whether policymakers act quickly enough to preclude a market riot, or whether markets will force them to act.

US Government spending



Source: Merrill Lynch.

The right recipe for the US?

More than other countries, the flexibility in the US economy portends a combination of strategies to address its fiscal policy. A likely series of events would be something like the following:

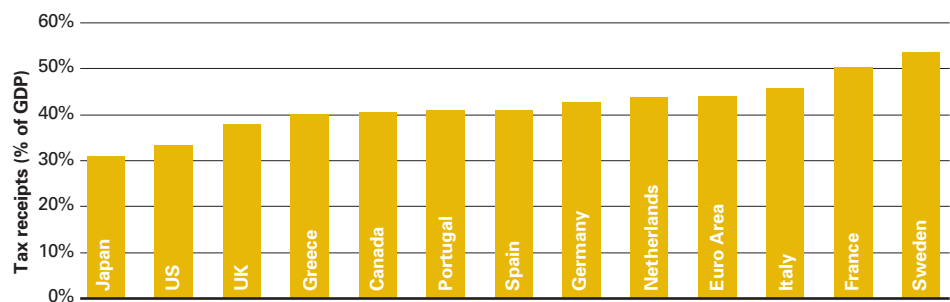
- Spur growth through traditional and non-traditional responses to the recession.
- Policymakers impose a steep hidden tax on savers via deeply negative real interest rates. The intent is to induce spending and slow the de-leveraging process.
- An open attempt to debase the currency through quantitative easing.
- Spending cuts to both defence and entitlement programmes, albeit in 2013 and beyond.
- Higher taxes on both corporations and individuals, as voters seek to retain their share of entitlement programmes.

Some of these elements have already unfolded. The recent pledge to keep interest rates near zero for at least two years is the equivalent of a savings tax. The next step may be to impose negative interest rates on bank reserves, in an attempt to stop banks from hoarding cash. Quantitative easing has already occurred twice, and a third phase should be expected before the crisis ends.

US spending can be trimmed, as it is less structural than it appears. Defence is still running at close to 5% of GDP, a rate more than double the pre-crisis level. Entitlement programmes account for nearly all of the long-term deterioration in fiscal finances, and will almost certainly come under the knife. It is easier to break the promises to constituents than default on debt, and that is what is likely to happen across the western world.

Higher taxes may seem unlikely given today's vitriolic debates, but the tide will shift as entitlement cuts loom and the ageing population ousts those politicians that fail to raise revenues to protect their retirements. Taxes in the US are much lower than most countries, as shown below, and there is considerable room to boost revenues as the pressure intensifies:

Taxes are lower in the US than most developed countries



Source: Bank Credit Analyst.

Bond markets are showing little concern about the creditworthiness of the United States. This is appropriate. We see little scope for a full-blown US fiscal crisis. The US is a debtor nation, but earns more on its holdings of foreign assets than it pays to foreigners. There is room to pare spending and raise taxes which, when coupled with modest inflation and currency depreciation, should place the country back on a sustainable debt trajectory by 2015. The key risk is another deep recession, which will materially exacerbate an already unhealthy fiscal position.

Japan

Japan is no Greek tragedy – the crushing debt burden of Japan

Japan – the world’s second largest economy – has racked up massive debt yet has faced little of the pillory to which indebted countries such as Greece have been subject. With current debt amounting to some 230% of GDP and a fiscal deficit representing 10% of GDP, the Japanese economy is ailing. Still, in spite of massive government debt, deflation and no economic growth for 20 years, the view on Japan remains sanguine. A key reason for this is that the public debt is financed by Japanese households, which have proved to be diligent savers over the years. More importantly, all of Japan’s government debt is denominated in its own currency. This gives Japan the ultimate buyer of last resort – the Japanese central bank.

Japan has sufficient levels of household assets to fund public debt

The Japanese debt burden is a legacy of government spending to buoy a stagnant economy following the bursting asset bubble of the 1990s. An ageing population in Japan, in common with many western economies, has increased social welfare costs and added fuel to the debt fire. However, the Japanese government is unlikely to default on its debt as the country has a large pool of domestic deposits to draw upon to fund its debt issuance. With the Japanese government reporting household assets of \$17 trillion at the end of September 2010, and a GDP of \$5.46 trillion in the same year, Japanese household assets are over three times the level of economic output.⁷ The government has almost no foreign currency-denominated debt obligations and more than 90% of Japanese government bonds are held by domestic investors. Since Japan’s public debt is mostly yen-denominated, Japan has the ultimate option of printing money to prevent a debt default.

The outlook for Japan - a Ponzi scheme with a twist

Quantitative easing (QE) should prove a successful policy option for Japan provided that inflation fears are kept in check. Devaluation of the yen would cheapen Japan’s exports, boost the trade surplus, strengthen the economy and stabilise debt concerns. Japan’s export growth (already having endured supply chain problems arising from this year’s earthquake and tsunami) is being hindered by economic woes in other parts of the world, but these should prove temporary.

Japan also has other avenues to raise funds. It is the world’s largest creditor nation, with net external assets of 251.5 trillion yen (\$3.1 trillion) at the end of 2010.⁸ Unlike Greece, it enjoys a steady flow of foreign earnings from a current account surplus. The yen’s status as a key international currency also helps Japan access external liquidity and markets, and the ratio of Japan’s tax burden to national income is one of the lowest in the OECD, leaving it room to raise taxes.

There is little doubt that the Japanese economy faces significant headwinds. Fears are growing that Japan’s ageing population will start drawing on their savings, forcing the government to rely on foreign investors to fund its debt. This could lead to a rise in Japanese government bond yields, but that remains a story for another day. In such a scenario, we would expect the Bank of Japan (BOJ) to come to the rescue. A sharp rise in yields would force interest costs to quickly balloon, creating a self-reinforcing spiral. This is an outcome the Bank of Japan must avoid at all costs.

Japan - a different kind of debt crisis

The markets usually equate a “crisis” with an abbreviated, highly chaotic downdraft in prices. But this is only one type of crisis. Japan has in fact been in its own debt crisis for more than a decade. The paltry yields on government bonds reflect the fact that markets see no immediate problem in the Japanese government securing ready buyers of its bonds. The yield on 10-year government securities in Japan has hovered near 1%

Regrettably, politicians are using the misguided comparisons with Lehman Brothers as an excuse to ignore and perpetuate Europe's real problem: an unhealthy, undercapitalised banking system and a monetary union based on the premise that political leaders' commitment alone could make economic and democratic realities disappear.⁹

for the last year and has been under 2% for the last decade on the back of deflation and near-zero short-term interest rates. This, however, is part of the problem. The Japanese government has crowded out the private sector and forced them to fund massive deficits at unappealing rates, creating a stealth tax on their wealth. Poor asset performance, low expected returns on investment, inefficient allocation of capital, and private sector deleveraging have all contributed to the quiet debt crisis of Japan, in which GDP has stagnated and asset prices have moved steadily lower for more than 20 years.

Bonds offer poor value in Japan, but that does not necessarily point to an imminent meltdown. The case of Japan is unique. It is a Ponzi scheme at its heart. More borrowing is required to fund the sins of the past, and this will ultimately collapse under the weight of ageing demographics and eye-watering debt to GDP ratios. This may be some way off, however, as the new investor in this Ponzi scheme will be the central bank itself. The policymakers running the Ponzi scheme are the very ones that can inject new capital when the old sources dry up, and therein lies the fundamental difference between the Japanese situation and traditional schemes.

The solution for Japan is a simple one – massive quantitative easing. With such a move, the yen would fall, deflation would ease and the great debt experiment will get another life. Such a radical step is not on the 2011 agenda, but should gain popularity in coming years.

Greece

While Japanese households hold the vast majority of Japanese public debt, in Greece about 70% of its sovereign debt is held by foreign investors.¹⁰ As a member of the European Union, Greece has no control over its currency and monetary policy. However, this same membership has enabled a €110 billion IMF/EU rescue package to be put together relatively easily and then again in 2011, a further €120 billion – the terms and conditions of which are still being determined. Still, at its core, it is the lack of economic independence of European countries that has led Greece and other peripheral countries to the edge of the abyss.

Greece has tested the euro to near-destruction

The economic impact of government debt differs depending on the use to which borrowings are put. In the case where the government is borrowing to invest in public services such as transport and education, it is possible that the productive capacity of the economy will be increased, enabling a higher rate of economic growth. Borrowing to finance transfer payments, pensions and healthcare for an ageing population, however, is a different story altogether.

This has been one of the failings of Greece. Blighted by significant economic problems for some time, the country was not a fitting candidate to join the EMU – indeed it was initially turned down. Two years later, in January 2001, Greece finally gained entry, albeit on the basis of fabricated accounts. Greece's cost of borrowing immediately fell and the country – rather than spending money to propel economic growth – ran up government debt by providing excessive benefits and permitting widespread tax evasion. Although private debt had been rising, the country's overall debt to GDP ratio did not balloon because the Greek economy was growing rapidly. The stability was a mirage. When the global economic crisis hit, Greece's deficit more than doubled.

The financial crisis in Greece provides a significant illustration of how things have gone wrong for the eurozone. Unlike countries with national currencies, Greece cannot address its problems through monetary policy. It can neither print money to inflate its debt away nor depreciate its currency to recover international competitiveness. It is a member of a union of countries which are highly asymmetric in their overall economic conditions and performance. Coordinating policy for common gains will remain elusive.

A failure to effectively contain the Greek debt crisis sent markets into a frenzy in June 2011, when Greece sought a second bailout. The panic reflected concern going beyond the probability of a Greek debt default to looking to a scenario of contagion spreading to other indebted eurozone countries. The Greek government was required to gain approval for a €78 billion (\$110 billion) five-year package of spending cuts, tax rises and state asset sell-offs to ensure the country receives the new aid package and so avoid the eurozone's first debt default. The current sticking point is how to engage private investors in the next stage of rescuing Greece.

International banks holding Greek debt

Location	Q4 2010 (\$ billion)
France	56.7
Germany	34.0
UK	14.1
US	7.3
Netherlands	5.0
Switzerland	2.9
Others	25.8
Total international bank holdings	145.8

Source: Bank of International Settlements.

The Greek crisis need not be a big issue for European banks if policymakers can preclude contagion from spreading to other countries. German lenders were the biggest foreign owners of Greek government bonds, with \$22.7 billion in holdings last year, according to data compiled by the Bank for International Settlements (BIS). French banks lead the group of Greek creditors with overall claims amounting to \$56.7 billion – a figure inflated by lending to companies and households, mainly because of Credit Agricole's Greek unit, Emporiki Bank.

The ECB and commercial banks have a vested interest in avoiding a Greek default or restructuring. They may succeed in delaying the inevitable, but will likely find it impossible to preclude a restructuring. The best solution for Greece is an engineered default. The country is insolvent, and imposing draconian austerity measures has only weakened growth to a rate far lower than the cost of the rates paid on the rescue package. This, in turn, has ensured that there is no avenue for Greece to reduce its debt. Greece must kick start its economy, but the government is broke and cannot provide stimulus. Nor is the private sector in a position to spur direct investment. Greece has uncompetitive wages versus the rest of Europe, a massively overvalued currency, political and labour force instability, default risk and the prospect of leaving the monetary union. No one will be willing to invest in such a climate. By propping up Greek banks and the Greek state, the ECB has taken on €190 billion worth of Greek assets, which will need to be written down, and banks will ultimately need to do the same.

For a truly insolvent country with no way out, default is the best option. This may not be the optimal outcome for the eurozone as a whole, but it is for Greece itself. A default is

not an option for Greece – the pain will be intense, but it is politically more acceptable than asking the next two generations of Greeks to make all creditors whole.

We expect Greece to initially go down a path of “effective” rather than “legal” default, with repeated changes to its bailout terms and the transfer of losses to banks and authorities. This should no longer qualify as a surprise. The problems of Greece are country specific and well documented, and the market has been adequately warned of Greece’s breaking points. Together, these factors suggest that a Lehman’s scenario is unlikely to eventuate in Greece, although there remains a risk that Greece will ultimately exit the eurozone.

Italy and Spain

Italy and Spain – the next dominoes to fall?

Italy and Spain are unique – countries not strong enough to stop the rot encroaching upon them, but not nearly as weak as the more stressed eurozone countries such as Greece, Ireland and Portugal.

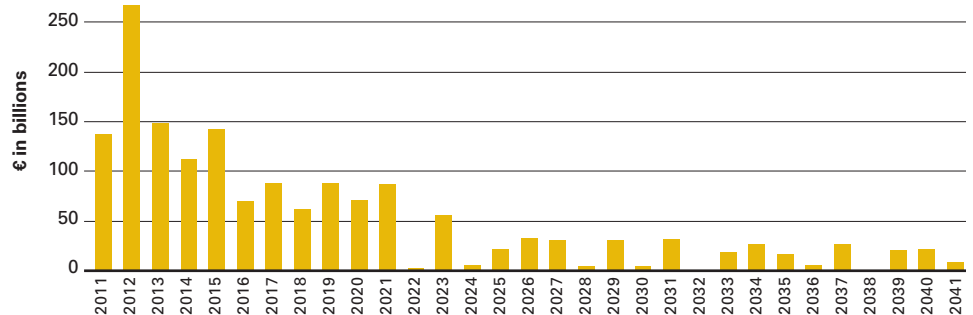
With proper policy steps, Italy and Spain should be able to withstand the current crisis. Italy is one of the few western economies running a primary surplus. It is heavily indebted, but this has been true for the last decade. Over this period markets have paid little attention to Italy’s high debt load, and thus suggestions that it has suddenly moved the country into crisis territory are not supported by the facts. The government has provided a credible fiscal plan and is not only sticking to it, but bringing the plan forward.

The issues that have returned these countries to the spotlight are:

1. Plummeting growth estimates for the eurozone and the world.
2. Incoherent eurozone policy.
3. Fears of a liquidity squeeze.

Again, growth is the key risk. A deep recession of -2 to -3% would potentially produce untenable debt trajectories in both countries and ballooning default risk premiums. Italy, in particular, also has a great deal of debt to refinance in the coming two years, as shown below, and could find itself struggling to roll over its maturing debt in such a scenario.

Italian debt maturity



Source: Bloomberg.

The numbers, however, point to a debt load which is sustainable. Under a scenario of sluggish 1% GDP growth, 2% inflation and a primary surplus of 2.7% (the average since EMU entry), Italy can see its average cost of borrowing escalate to 5.5% before the burden becomes unsustainable. The average rate is currently 3.98%. Italy simply requires supportive policy and growth.

The recent decision of the ECB to begin buying both Italian and Spanish bonds is very significant. Spain and Italy represent liquidity problems and not solvency problems, which separates them from the likes of Greece. Liquidity can be addressed by a central bank, whereas the ECB is powerless to reverse a true solvency crisis. The bond-buying programme simultaneously showed that policymakers would cease being dogmatic and also that policymakers understood the dangers of allowing a liquidity problem to turn into a solvency problem. Many have expressed frustration at the plight of European economies, claiming that markets are unfair. Spain and Italy have better credit metrics than other regions – such as the US and Japan – yet trade at much higher yields. The markets are not unfair. Yields in stretched regions are not determined simply by ratios; they are driven by the available policy options. Without a supportive central bank and a flexible currency, Italy and Spain are in a weak position to combat a crisis.

We believe Spain and Italy will survive. Volatility will remain high, as both Spain and Italy currently lack a buyer of last resort. We expect the eurozone to take more steps in the coming months to better ensure that the commitment to support these markets is more open-ended, as policy options are becoming limited. One option is to allow default in the severely weakened economies whilst ring-fencing the core economies. A second option would be quantitative easing. A third option, in which countries are bailed out by member states and the IMF as they encounter stress, is no longer viable. Italy and Spain are simply too large. Italy alone has 1.9 trillion euros of debt, more than 75% of Germany's annual output.

Monetisation, whereby central banks use newly created money to finance the region's debt burden, will likely prove the ultimate solution, but this is not imminent. New ECB leadership will be necessary, and it is likely that deflationary pressures will need to be pronounced before such a step would be embraced. Some countries, such as Germany, will be vehemently opposed. In the meantime, both countries will be hoping for growth. The scenario that would spell doom for both economies is a deep prolonged recession.

United Kingdom

The outlook for the UK

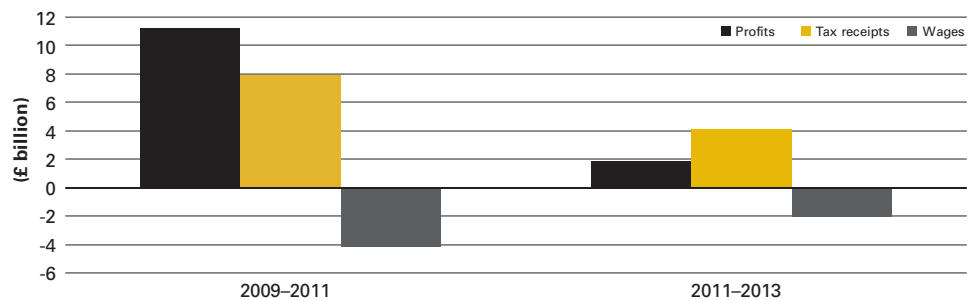
The United Kingdom has been the most forceful proponent of austerity. It took tough steps to bring large budget deficits under control and was lauded for its proactive and prudent approach. Taxes were raised and spending cuts were extended across nearly every area. A year into the programme, it seems a good time to revisit whether or not it is working. The underlying premise of austerity is that deep spending cuts do not hinder growth to such an extent that tax receipts drop even more precipitously. If policy crushes revenue more than the associated drop in spending, the experiment is a failure. Pain is inflicted on the economy, but without any offsetting improvement in indebtedness. Such a policy is highly unstable, and typically leads to social and political unrest.

The early results are not good. Sluggish growth in the UK has improved revenues from the lows, but the take has been disappointing. Borrowing, rather than falling 4% as the government predicted last year, is running only slightly below levels of a year ago. At this pace, significant improvement in debt/GDP ratios will take 15-20 years.

It is not yet clear that the austerity programme embarked on by the UK will succeed. The strategy historically has been used by smaller countries that rely on the positive growth effects of the larger global economy. Regions of strong global growth “lift” the struggling economy back to its feet. The problems today are that 1) the UK is too big and 2) the “lift” from the rest of the world is turning into a drag. If the foreign sector will not drive growth, it is equally clear that the domestic government sector cannot drive growth. That leaves the private sector to do the heavy lifting, but consumers are beset by falling real wages. Corporations are in better shape, but the outsized UK banking sector is still trying to shrink its balance sheet. The numbers simply do not add up. There are not enough savers to finance the “dis-savers”.

The chart below shows the way in which key components of the UK economy have progressed, and what can be expected if growth fails to improve.

Net change in profits, tax receipts and wages (adjusted for inflation)



Source: Bank Credit Analyst.

The UK will likely choose more quantitative easing. Currency debasement appears to be one of the only tools available to policymakers. The next round of QE is likely to require further weakening in real growth and clear evidence of cresting inflation. It is also likely to require someone else to move first. The UK is one of the few regions that might benefit from attempts to inflate the economy out of its debt load. The UK has a large percentage of debt held by foreigners, and has the longest duration of debt maturities (>14 years) in the industrialised world.

Conclusion

We have seen that there are no simple solutions to the world's current crisis. Many developed economies are only now just facing the painful realisation that living beyond one's means has come to an end. The path to sustainability will be long and arduous.

There are only a limited number of policy options still open to indebted developed economies. Traditional policy responses are no longer viable. Various policy combinations will be attempted, the pace of reform will test the markets' patience and mistakes will be made. Markets will remain fickle and it is not possible to know what they will bear at any point in time. Managing volatility will therefore be key to future investment success.

The view that unsustainable debt trajectories must end in default is overly pessimistic. Unsustainable trends can also become sustainable, as has happened repeatedly throughout history. Markets will likely oscillate between pessimistic and optimistic extremes. Periods of weak growth and policy inaction will push default fears sharply higher. A healthier backdrop and periods of strong leadership will produce the opposite.

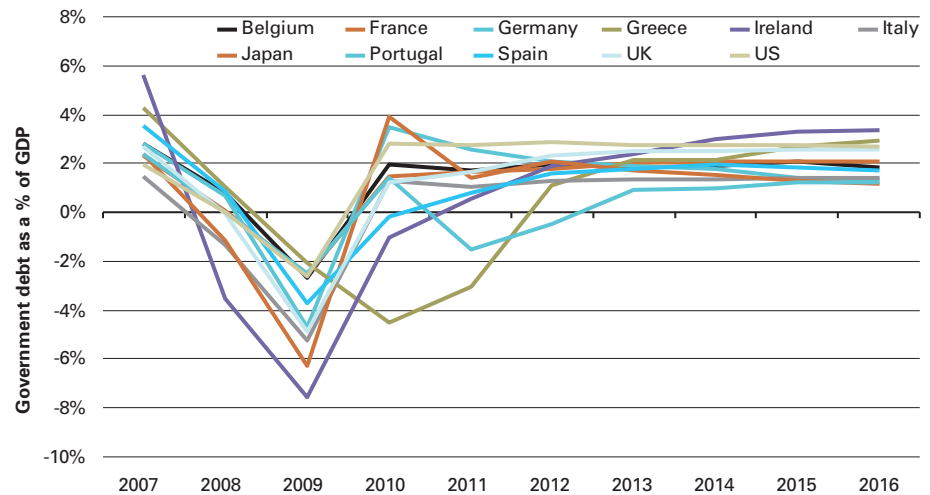
Ultimately, we believe the optimists will be proven right for most economies. The remedy for an excessive debt load is time and growth. Both are critical and policymakers must be adroit in their role to ensure that greater confidence will nurture the global economy. Events in the political arena are unfolding fast. Timely policy responses are important to limit the collateral damage from ongoing volatility. Accordingly, we will be regularly updating this paper. Watch out for more of our 'Threadneedle Thinks' market commentaries throughout the year.

Appendix

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