European Debt Crisis

Europe's sovereign debt crises are changing daily, yet are making little progress toward long-term solutions. The only questions are when, how and who will be left holding the bag?

NAI DESCO
Commercial Real Estate Services, Worldwide.

October 2011

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Why is it that drops in asset values associated with impaired debt undermine economic activity far more than larger drops in equity values do? For example, during the tech bubble and the subsequent crash, $5 trillion in economic value disappeared over 30 months on the U.S. stock markets. This dwarfs the decline in asset values associated with impaired debt during the financial crisis, which are perhaps $1-2 trillion. Yet the real economy quickly regained its balance even after trillions of dollars were wiped out on the stock market, while far smaller losses via impaired debt have constipated economies across the globe. No clearer example exists than Japan over the past 21 years. And now Europe is following suit.

The reason is that when equity value disappears, it is the end of the story. People feel poorer, pick themselves up, dust themselves off, and focus on recreating value by new productive economic activities. In contrast, when value is destroyed via impaired debt, debt contracts allow participants (think: Europe) to argue endlessly about who will bear the burden, rather than spending their resources moving forward. Think of the time and money diverted to lawyers, courts, experts and accountants associated with trying to avoid the losses associated with contractual debt. And the stakes of this contractual gridlock are elevated to the extreme when the debtors are countries, rather than companies. This is particularly true when the debt is held by a "national hero" bank that is viewed as too precious (and too politically connected) to fail.

This focus on "who loses" rather than "how do we create value" is accentuated when the impaired debt losses are large, as the dominant role of banks as lenders means that government policy is invariably dragged into the fray. This imposes regulatory uncertainty on the economy, and political efforts to redistribute a smaller pie rather than creating a bigger pie. And since banks invariably are large losers in situations of large impaired debt losses, the specter of the survival of the heavily leveraged insured depositories surfaces. The result is that impaired loan losses freeze the system, allocating scarce capital to alleviating past losses, with banks becoming agents of redistribution, rather than value creators.

Herein, we present a summary of Europe's financial turmoil. While the headline news reports are dominated by Greece's woes, other European nations, including Portugal, Spain, Ireland and Italy also have serious issues.

Greece. Greece was accepted with great fanfare into the euro zone in June 2000. But it became clear in 2004 that Greece only managed to qualify by using falsified financials. Reported GDP was inflated 25% via the

Government* Spending, % of GDP

Country	1870	1913	1920	1937	1960	1980	1990	2000	2005	2009
Austria	10.5	17	14.7	20.6	35.7	48.1	38.6	52.1	50.2	52.3
Belgium	*na*	13.8	22.1	21.8	30.3	58.6	54.8	49.1	52	54
Britain	9.4	12.7	26.2	30	32.2	43	39.9	36.6	40.6	47.2
Canada	*na*	na	16.7	25	28.6	38.8	46	40.6	39.2	43.8
France	12.6	17	27.6	29	34.6	46.1	49.8	51.6	53.4	56
Germany	*10*	14.8	25	34.1	32.4	47.9	45.1	45.1	46.8	47.6
Italy	13.7	17.1	30.1	31.1	30.1	42.1	53.4	46.2	48.2	51.9
Japan	*8.8*	8.3	14.8	25.4	17.5	32	31.3	37.3	34.2	39.7
Netherlands	9.1	9	13.5	19	33.7	55.8	54.1	44.2	44.8	50
Spain	*na*	11	8.3	13.2	18.8	32.2	42	39.1	38.4	45.8
Sweden	5.7	10.4	10.9	16.5	31	60.1	59.1	52.7	51.8	52.7
Switzerland	*16.5*	14	17	24.1	17.2	32.8	33.5	33.7	37.3	36.7
United States	7.3	7.5	12.1	19.7	27	31.4	33.3	32.8	36.1	42.2
Average	***10.4***	**12.7**	**18.4**	**23.8**	**28.4**	**43.8**	**44.7**	**43.2**	**44.1**	**47.7**

Sources: Vito Tanzi and Ludger Schuknecht; IMF; OECD

*1870-1937 Central Government, 1950-2009 General Government

inclusion of black market activity in economic output, magically reducing the deficit as a percent of GDP to 2.9%, even though no taxes were collected on this part of the economy. Giorgios Papakonstaninou announced recently that the deficit would reach 12.7% in 2011, while the Maastricht Treaty prescribes a limit of 3%. In fact, Greece has only complied with the Maastricht Treaty once since the introduction of the euro in 2006, and who knows if even that year would stand up to a scrupulous audit.

On April 23, 2010, the Greek government requested a bailout package of €45 billion ($61 billion) from the EU/IMF. The Greek debt rating was reduced to BB+ (junk) by Standard and Poor's 4 days later. Not surprisingly, this initial bailout did not suffice (nor, by the way, will the second or third). As a result of austerity measures proposed in Greece on May 1st, Germany was persuaded to sign a €110 Billion EU-IMF loan package over 3 years at an interest rate of 5%. At the time of the bailout, the Greek deficit was at 10.5% of GDP, and the country's debt (€328.6 billon) was 142.8% of GDP. The austerity-linked bailout was greeted with riots and violence in Athens, resulting in 3 deaths.

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Following half-hearted austerity measures consisting of public sector pay cuts, pension reductions, new taxes on company profits, an increase on luxury and sin taxes and an increased VAT aimed to save €30 billion through 2012, the country's economy has continued to deteriorate. Unemployment has risen 480 bps since the 2010 bailout of Greece, standing at 16.2% in the second quarter of 2011, and a staggering 42% among those under 24 years old. Many have withdrawn into an ever growing black market economy.

It has always been clear that Greece would default on its loan repayments to Germany and France in July 2011 if further assistance was not granted. A vital vote was passed in Athens on June 26, 2011 introducing further austerity measures as part of the second Greek bail out.

With the Greek economy (or at least the measured economy ignoring black markets) forecast to contract further this year, it is impossible for the country to make any headway in relieving its debt burden in the near future. Fundamental debt forgiveness is required along with reducing the huge black market sector. Greece will default on its debt. The only questions are when, how and who will be left holding the bag? It is a game of Old Maid – who ends up holding the losing card, as there will inevitably be a loser. But a default of some form is inevitable as the numbers simply do not work. Delays and restructurings merely postpone the inevitable, and raise economic uncertainty about "who holds the old maid".

Preventing default on Greek loans is of direct importance to prevent losses at Europe's banks. If a default occurs, French and German banks will suffer. In turn, they will be supported by their national governments, who are keen to protect their local hero banks. In the meantime, the portion of the Greek economy which is underground stands at a staggering 30%, and growing. This huge underground sector goes untaxed while consuming government services, and government fraud and abuse remain world class.

Portugal. Portugal's debt rating was cut to junk status in the first week of July 2011 by Moody's Investors Service. This applies further pressure on euro zone governments to determine a lasting solution to the country's financial disarray. The news of this decision to reduce Portugal's rating is, in fact, even worse than at first glance. Despite austerity measures introduced as part of the $116 billion rescue package negotiated in May, the bailout has, not surprisingly, failed to stabilize Portugal's debt-to-GDP ratio (currently at 90.6%). GDP contracted in the first two quarters of 2011 by 150 bps. The rating agencies believe that private sector lenders will have to share the burden should any further bailout be implemented.

The newly formed government's Prime Minister Coelho has announced the government will need to raise taxes further to reach its budget deficit target. The traditional Christmas bonus that is the equivalent to one month salary will be subjected to a 50% tax. This scheme is intended to raise €800 million ($1.2 billion) in additional tax receipts. The construction of a new high speed rail link between Lisbon and Madrid has been halted to cut public spending. Regardless of these cuts and other

measures, Portugal's economy is still expected to be in recession for the next 2 years, making it impossible for the country to grow out of its debt burden, thereby increasing the risk of default. In addition, banks are going to be required to roll over loans for a longer term at a lower interest rate.

Italy. Italy owes about 25% all government debt in the euro zone. On July 5, 2011 Italy's borrowing costs soared to a euro-era high due to a lack of market confidence in Italy's ability to service its €1.9 trillion ($2.6 trillion) debt, or 120% of GDP by year end. Italy has the largest sovereign debt market in Europe and the third largest in the world. Yields on 10-year bonds jumped by almost 100 bps in two trading days (touching 6%). Credit default swaps offering investors protection in the event that a default reached 325 bps, resulting in a decline of 0.8% against the dollar to $1.393. An auction of €6.75 billion in 12-month bills at a yield of 3.67% (a high since 2008) temporarily eased the pressure on Italy.

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French banks held almost $100 billion of Italian sovereign debt at the end of 2010. The $100 billion owed by Italy to France is greater than the total owed to France by Greece, Ireland and Spain combined.

Italy has proposed a 3 year austerity package to reduce the budget deficit by 2014. The deal must be approved in Parliament, where Silvio Berlusconi retains a slim majority. A freeze on public sector salaries and hiring will be extended through 2014. Military operations abroad have been cut by €200 million ($287 million), resulting in a reduction of personnel in Libya.

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Ireland. The official EU-IMF position is that Ireland will return to borrowing in the sovereign debt markets in late 2012, and will be able to do so at interest rates that will allow its debt level to stabilize. The European Commission's projections are for Ireland's debt to peak at 120% of GDP in 2013, slowly declining thereafter. The average interest rate on the EU-IMF debt (45% of GDP) is higher than that on existing debt, but it also has a 7.5 year maturity. As a result, Ireland will not be under huge pressure over the next few years to replace this funding with private borrowing.

Spain. While the economies of Greece, Portugal, Italy and Ireland are in turmoil, due to their relatively small sizes, these problems are somewhat containable. Spain's GDP in 2010 amounted to nearly $1.5 trillion, which is greater than all those aforementioned economies' output combined. Spain entered the crisis with comparatively low public debt at 36% of GDP in 2007. The figure has rapidly risen, though to a still manageable 63.9% during the first 2 quarters of 2011.

Although Spain is not in a recession, GDP growth currently is just 0.8% with an annual budget deficit of 6.8%. Therefore, the Spanish deficit as a percentage of GDP is growing rapidly. A further Spanish dilemma is the skyrocketing unemployment rate, currently at 20.9%, the highest in the European Union. Barriers to firing employees have resulted in employers taking on new staff abroad or via temporary contracts. Companies have decided to base a majority of staff abroad to avoid the domestic employment regulations, further stunting economic growth.

Outlook. As the economic situation worsens in a growing number of euro zone countries, European leaders have been discussing the appropriate way to move forward and overcome the escalating debt crisis. Germany ($22.7 billion) and France ($15 billion) are the largest creditors of Greek debt. The largest disclosed holding of Greek debt by a non-Greek European bank is with BNP Paribas with €5 billion ($7.1 billion), with the top 30 holders of Greek debt accounting for nearly two-thirds of the total debt. In theory, this will make negotiations in restructuring debt repayments more likely to succeed.

The principal danger is that when Greece defaults, either voluntarily or involuntarily, there will be considerable capital market uncertainty and renewed rounds of government interventions to save local banks. The extent of the default contagion in these economies such as Italy, Portugal, Ireland and Spain will very much depend on the nature of the Greek default and the way in which creditors

structure future interest and principal payments, as well as how Germany and France treat losses by their banks. The problem is that all of these are unknown, and uncertainty hampers economic growth.

The reality is that Greece, at some point in time, will default on its debt payments. The priority of the German and French debt holders is for this default not to have the public appearance of a default. By making it appear 'voluntary', it may avoid panic and contagion. The French banks initially indicated that they are willing to roll over the debt to a 30-year period at a lower interest rate. German banks followed in this proposal of what would be a €3.2 billion roll-over. Due to the heavily exposed nature of Greek banks, a default could trigger a run on the banks resulting in the most exposed banks being nationalized. Furthermore, a default would spark the payout of credit swap contracts against a Greek default. As similarly overwhelmed countries, such as Ireland and Portugal look on, the notion of default could become more appealing as a solution to their problems. This 'domino effect' could, in the extreme, result in the insolvency of the European Central bank and at minimum, will trigger continued meddling and great uncertainty, and reduced risk-taking by employers.

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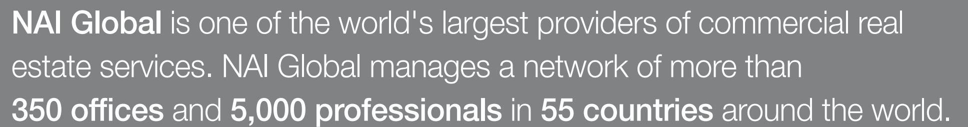
It has become evident that as the debt levels in a growing number of European countries escalate, a rollover of debt is not a long-term solution. It will delay, and worsen, the necessary haircuts on bonds held both publicly and privately throughout Europe. The simple fact is that German and French banks profited in the past by lending more money, far too cheaply, to Greece and others, and the day of reckoning is here. Yet no one wants to take the loss. Hence, the muddled meddling. A rollover deal could in fact incentivize a Greek default, due to increasing the cost of debt service. The nature of the euro crisis changes daily, and will continue to do so until a lasting solution is brought to fruition.

As of mid-September, the idea of a 'eurobond' gained momentum – at least everywhere but Germany – as a proposed solution to the crisis. At an August 29th conference of the European Parliament's Economics Committee, the EU Commissioner for Economic and Monetary Affairs, Ollie Rehn stated, "It is clear that eurobonds, in whatever form they were to be introduced, would have to be accompanied with a substantially reinforced fiscal surveillance and policy coordination as an essential counterpart."

European Central Bank President Jean-Claude Trichet stated earlier in the day that inflation could remain above the bank's target level of 2% "over the months ahead" and predicted that growth would continue at a "modest pace."

Meanwhile, the most pressing issue remains that Greece is awaiting another bailout package, as the European leaders spar over the terms and the reality that Greece will never pay back its debt in full. Thus, the meddling continues, rather than taking losses and moving on to future growth.

The upside is that the distress of Europe's banking sector could present investment opportunities for real estate investors. The European Banking Authority recently released its 2011 EU-Wide Stress Test Report, which indicated that the 90 EU banks in its survey had an overall Core Tier 1 capital ratio of 8.9% in 2010, but in 2011, 8 banks fell below the 5% threshold, and 16 banks had capital ratios between 5% and 6%. The Basel I Capital Accord recommends a minimum Tier 1 capital ratio of 4%, but 10% is generally targeted by investors. As a result, EU banks seeking to strengthen their capital and liquidity positions will be in disposition mode to unload parts of their commercial real estate holdings, including debt portfolios and REO properties.



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