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Debt Crisis in the Euro Zone : Is There a Way Out?

**Cbonds Fixed Income Conference:
Russia, CIS & CEE**

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Causes of the Debt Crisis

- Current large-scale debt crisis in the euro area is actually a **consequence of "victory"** over the global financial crisis of 2008-2009.
- Also before the financial crisis some developed countries "lived beyond their means".
- But it is the struggle against the global financial crisis and its consequences that led to a sharp rise in public debt of many developed countries.

Country	Public debt	2011		2010		2009		2008	
		Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP
Japan	\$12 trillion	233%	-10%	220.3%	-9.5%	216.3%	-10.3%	195%	-4.2%
Greece*	€360 billion	165%	-7.4%	142.8%	-10.5%	127.1%	-15.4%	110.7%	-9.8%
Italy	€1.9 trillion	121%	-4.4%	119.0%	-4.6%	116.1%	-5.4%	106.3%	-2.7%
Ireland	€177 billion	106%	-10.8%	96.2%	-32.4%	65.6%	-14.3%	44.4%	-7.3%
Belgium	€355 billion	100%	-3.9%	97.1%	-4.1%	96.2%	-5.9%	89.6%	-1.3%
USA	\$15 trillion	100%	-10.3%	91.6%	-10.6%	84.6%	-12.7%	71.2%	-6.4%
Portugal	€156 billion	93%	-5.6%	93.0%	-9.1%	83.0%	-10.1%	71.6%	-3.5%
France	€1.7 trillion	87%	-6.0%	81.7%	-7.0%	78.3%	-7.5%	67.7%	-3.3%
UK	£1.3 trillion	86%	-8.4%	80.0%	-10.4%	69.6%	-11.4%	54.4%	-5.0%
Germany	€2.1 trillion	85%	-2.3%	83.2%	-3.3%	73.5%	-3.0%	66.3%	0.1%
Spain	€693 billion	68%	-6.1%	60.1%	-9.2%	53.3%	-11.1%	39.8%	-4.2%

Source: Bloomberg, Eurostat, EconomyWatch

* after restructuring in March 2012, public debt of Greece fell from €360 billion to €253 billion, and its ratio to GDP from 165% to 130%

Causes of the Debt Crisis

- According to the Maastricht criteria, public debt above **60% of GDP** is dangerous to public finances.
- After a sharp rise in public debt, this level remained "far behind" for many developed countries.
- Developed countries, once the most reliable borrowers, have come really close to sliding into a debt crisis and default.



Causes of the Debt Crisis

- Not only euro area countries, but also UK, US and especially Japan can enter into debt crisis.
- But the market (i.e., speculators) has chosen the weak euro zone countries to be the “victim”.
- The reason is the systemic weakness of the union: especially absence of the unitary financial control and financial aid mechanisms.



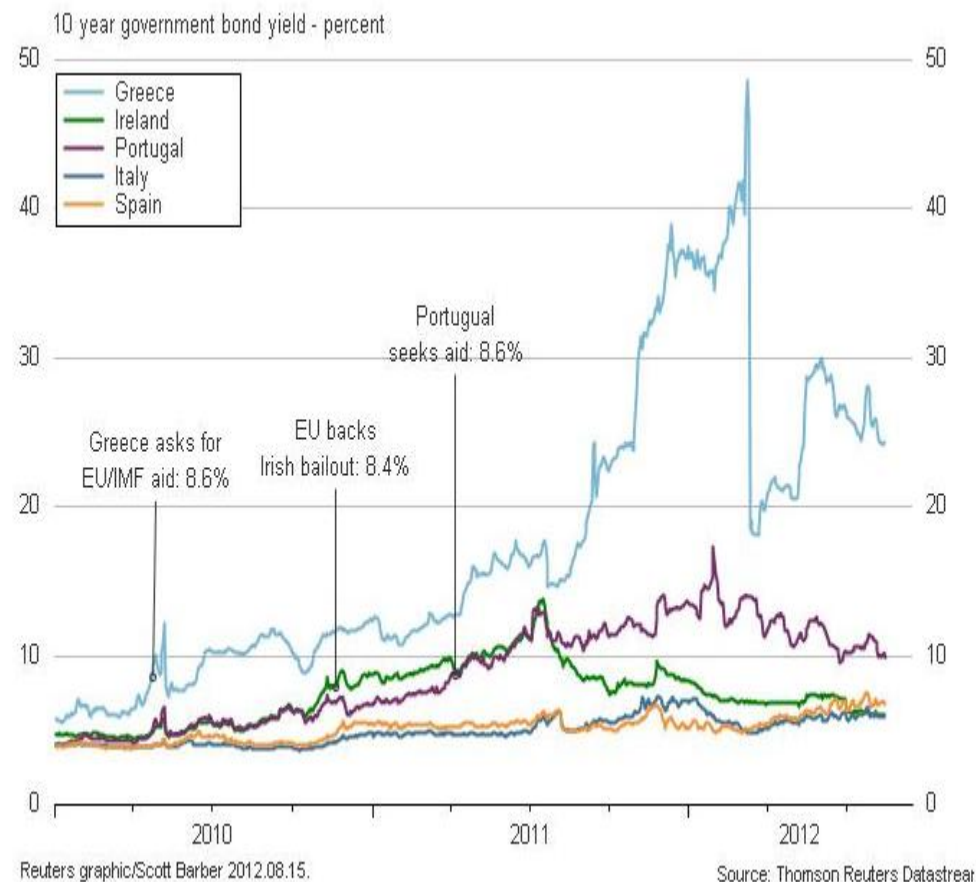
A Brief Chronology of the Crisis

- The crisis came in 2010, with a sharp drop in prices and increase in yields of Greek bonds.
- In **April 2010** Greece appealed for help in refinancing the debt to the European Union and the IMF.
- The country was provided two support packages: €110 billion in May 2010 and €130 billion in March 2012.
- Nevertheless, in **March 2012** Greece wrote off **50% of the debt** held by private investors.



A Brief Chronology of the Crisis

- In 2010, bonds yields of other ailing euro area countries, named PIIGS, started to increase.
- In **November 2010**, when yield on 10-year bonds exceeded 8%, Ireland also applied for aid.
- In **April 2011**, given the same figures, Portugal did the same.
- At the **end of 2011**, a loan from the European institutions was requested by Cyprus, but was refused (€2.5 billion were lent by Russia).
- In **June 2012**, Spain and once again Cyprus asked for non-market lending.



A Brief Chronology of the Crisis

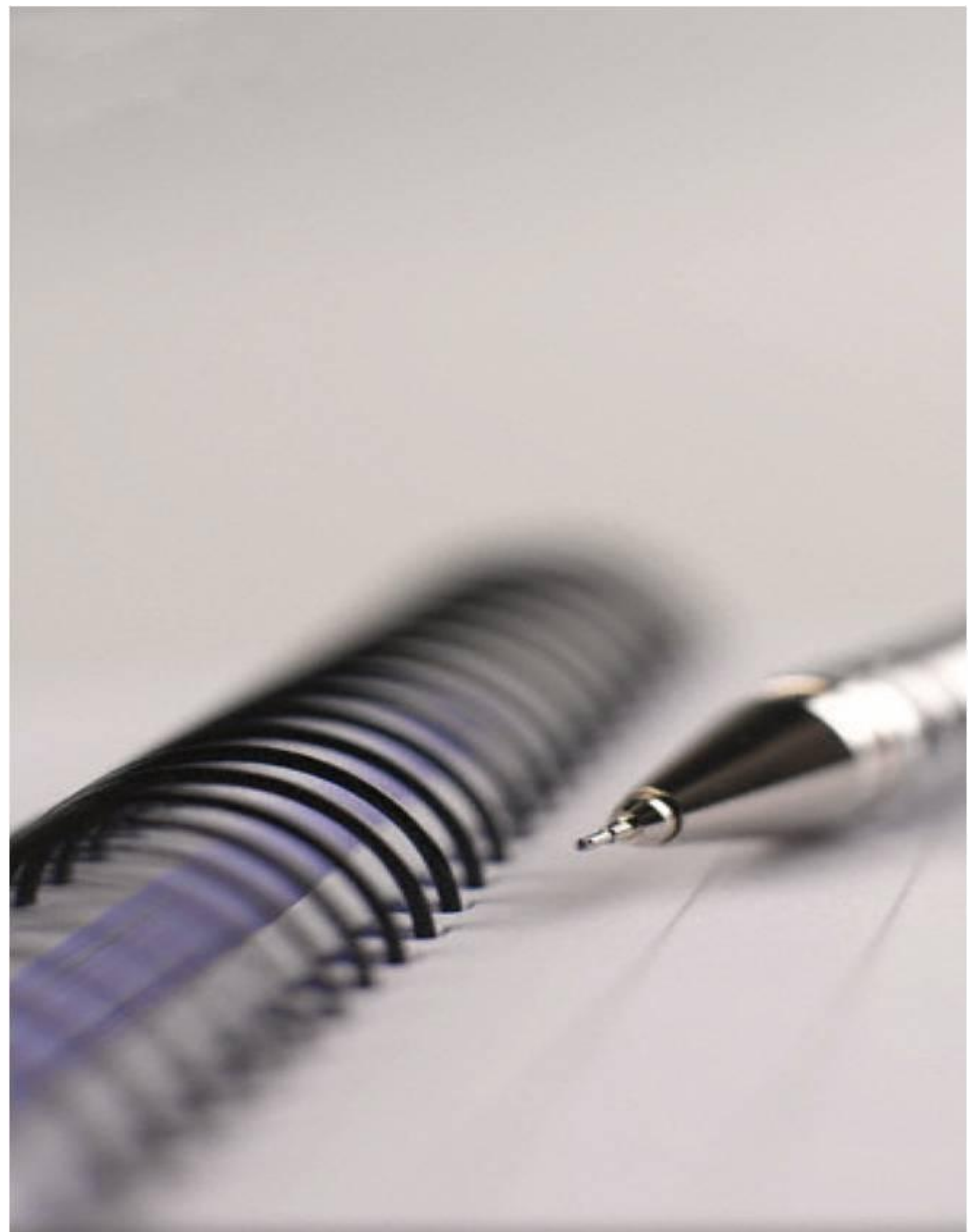
To date, the financial aid plan from the EU and the IMF, amounting **from 10% to 110% of GDP**, has been already approved for 4 countries, but this has not led to the normalization of market interest rates.



Source: Financial Times

Actions of the European Authorities: Too Little, Too Late

- European political and monetary authorities have taken a number of measures to combat the crisis.
- European leaders held **19 anti-crisis summits!**
- There were adopted EFSM, EFSF, and ESM financial aid mechanisms.
- The Stability Pact, the Growth and Employment Pact, and other important documents have been signed.
- Steps towards establishing a fiscal and banking union have been made.

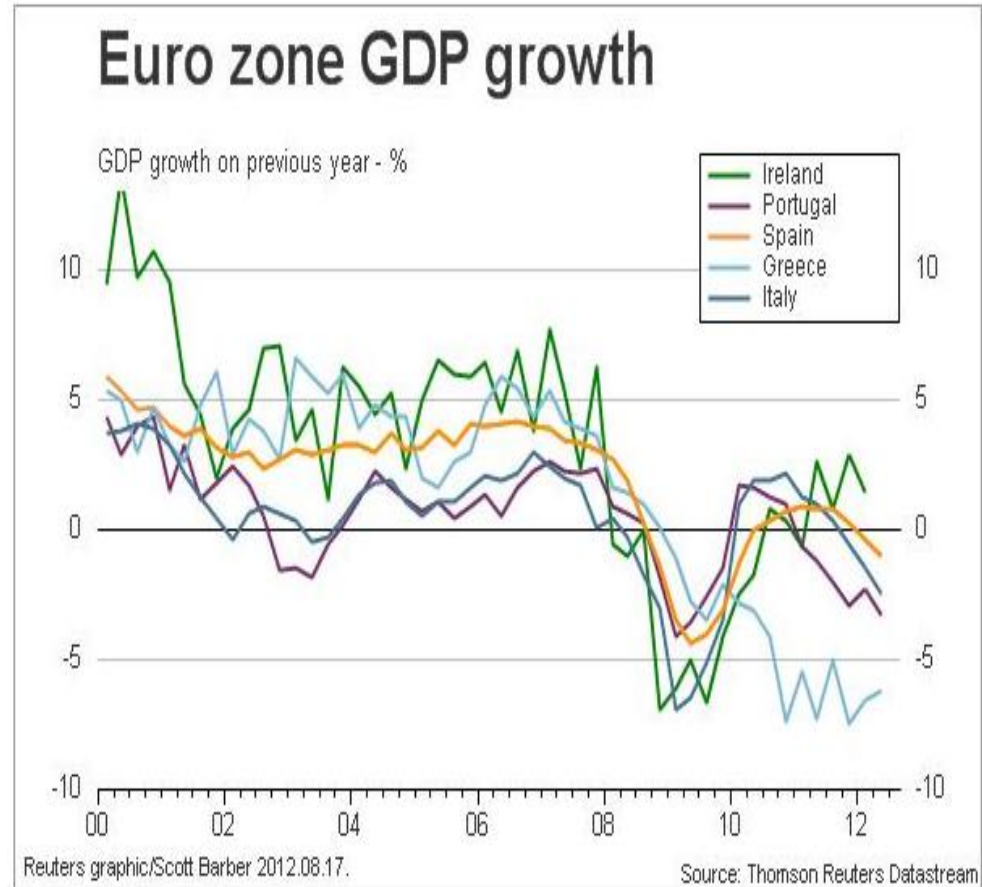


Actions of the European Authorities: Too Little, Too Late

- In turn, the ECB several times bought up the bonds of troubled countries on the market (but worth only **€220 billion**).
- It launched LTRO program in December 2011, increasing the balance by **€1 trillion**.
- And in 2012 it lowered the financing rate to a record low **0.75%** (although it increased the same twice in 2011).
- However, the authorities have always lagged behind the situation, following the principle: **too little, too late**.
- Moreover, certain actions or omissions, probably, were erroneous (rate increase, weak QE, refusal to issue common euro area bonds, etc.).

Ways Out of the Crisis

- The current crisis has extremely negative impact on the global economic process and financial markets.
- Troubled countries repeatedly entered the recession, and growth of worlds' GDP has slowed sharply.
- The financial market instability is fraught with a new financial crisis.
- Therefore, overcoming the crisis quickly is vital to the global financial and economic system.



Ways Out of the Crisis

- It should be noted that crisis is in fact the **crisis of investor confidence**, reinforced by speculators.
- Accordingly, it is necessary to restore market confidence in order to overcome the crisis.
- In our opinion, the ways of achieving this goal can be divided into two types.
- The **fundamental ones** – by improving fundamentals of the issuers.
- And the **technical ones** – by stabilizing the market, given the current "weak" foundation.



Ways Out of the Crisis

Fundamental Ways

- Reducing the debt burden of the euro zone countries as a result of real GDP growth at high rates.
This would be the best solution, but it looks highly unlikely.
- Reducing the debt burden as a result of rapid growth in nominal GDP, i.e., inflationary solution.
It is not the best for debt holders, since their assets become devalued, but not the worst one. However, this solution does not seem feasible because of the ECB tough stance on inflation.
- Reducing the debt by carrying out partial controlled defaults - an option which is now "given a trial" in Greece.
This solution is rather painful for debt holders. Moreover, large write-offs can be dangerous for the stability of the whole financial system.
- A similar to inflationary solution can be produced by devaluation of the euro.
But in modern currency system, there is no mechanism of one-time devaluation of free currencies, and it is in the competence of the free market.

Ways Out of the Crisis

Technical Ways

- Achieving low rates in the market by "partial monetization" of bad debts – the active participation of the ECB (EFSF, ESM) in buying securities from the market. The method used by central banks of Japan, UK and USA, and it is actually being negotiated by the EU leadership.
- Replacing the national bonds with much more reliable common ones. The ratio of total debt to the euro area GDP is 87%, whereas in the USA it is 100% and in Japan – 230%.
Meanwhile is strongly opposed by Germany.
- Achieving low rates by introducing strict market regulation measures: ban on shorts, regulation of CDS market, and other measures limiting speculation. Currently lacks support from the political leadership of the EU and other leading countries.

Or a combination of proposed ways in a certain proportion.

Ways Out of the Crisis

Can there be other ways
out of the crisis?

What needs to be done?

Let's discuss!





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Thank you!

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