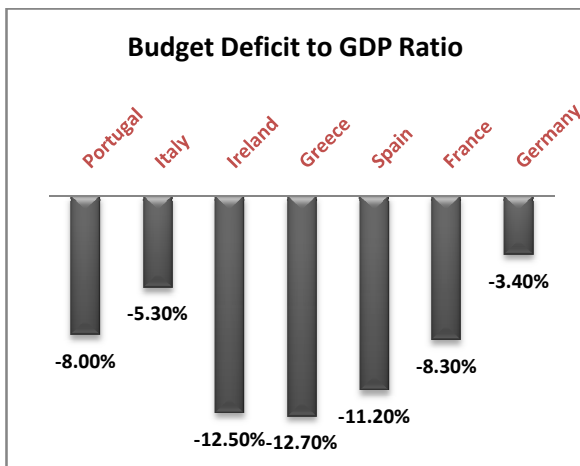
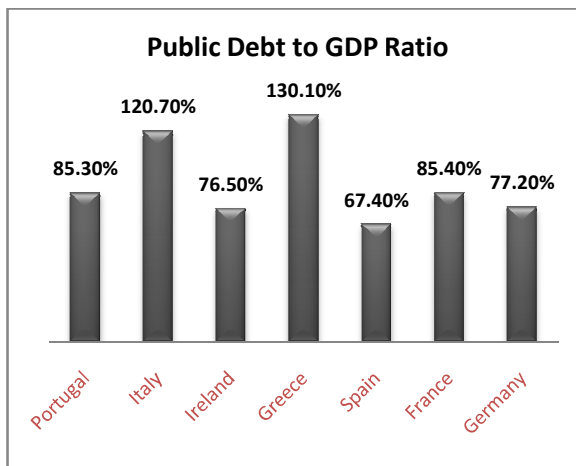


Recent month's newspapers were covered with lot of news about the Sovereign crisis faced by a number of European countries, being collectively referred to as PIIGS (Portugal, Ireland, Italy, Greece and Spain). These countries share similar financial characteristics in that they maintain significant budget deficit as a percentage of GDP, high Debt to GDP ratios and generally high unemployment rates relative to other Euro zone countries. Also, these nations have relatively high labor costs compare to other big Euro countries, which makes it very difficult for these countries to survive the competition.



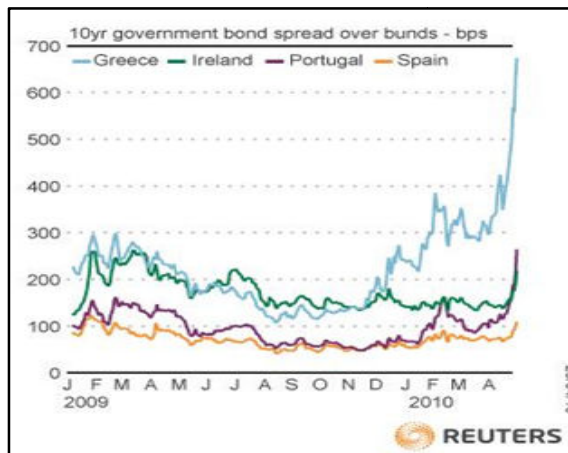
Source: European Commission



Source: The Economist

**Why the problem started with Greece?**

The Greek finance minister however described the effort to steer Greece away from economic disaster as “changing the course of the Titanic”. Until recently last week it looked as if the country was headed for an iceberg labeled default. The Standard & Poor’s cut’s the rating of Greece sovereign bonds to “junk” status and also cut the rating of Portugal and Spain’s Sovereign bonds. It also cut Greece's banks to “junk” because of their hefty exposure to government debt. Earlier debates which used to circle around whether Greece would default or not, has now took shape of how it should tackle this situation, where to get funds from and at what cost etc.



The Greece has been in headlines mainly because of the refinancing hurdles it faces in May, when roughly €10B comes due. It also has the most severe budget deficit of its PIIGS compatriot's as shown above. These issues have led the investors to disdain the Greek bonds, resulting in 10-year Greek bonds trading over almost 400bps above German Bonds.

Why it happened will be concentrated into three parts, firstly we will talk about the political issues which will be followed by the economic issues.

Closer examination of the political situation in Greece leads us to a conclusion that Greece may be suffering from an inoperable cancer, in the form of a degree of corruption that make a resolution without bankruptcy very difficult to implement. Corruption in Greece has been systematically cultivated by all governments and parties. Everyone has relatives living off the public sector in cushy, do-nothing jobs. They get paid through various funding sources that successive governments have created. Another Corruption is that the rich by large do not pay any taxes. The only people who pay are those who can't escape the hands of the state.

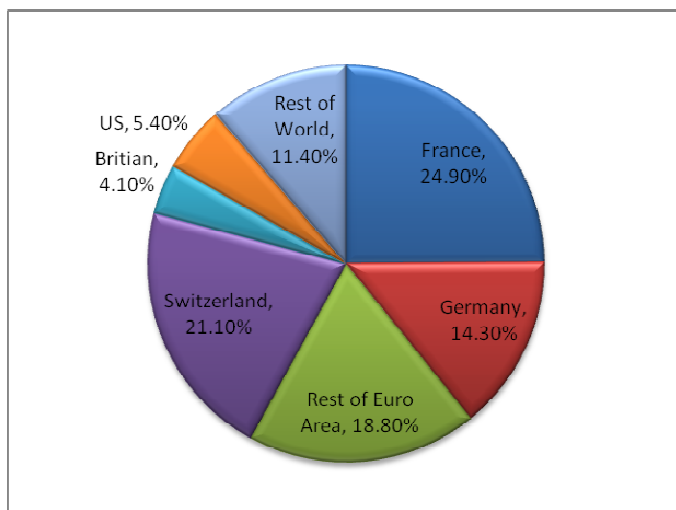
According to the president of the National Bank of Greece, 30% of the budget of the last administration was unaccounted for-yes; it just disappeared into the coffers of their families and well-wishers.

Now discussing some of the economic issues, the fact is that since 2000, inflation in Greece has averaged 3.39 per cent. In Portugal it was 2.6 per cent. In Ireland it was 2.95 per cent, in Italy it was 2.33 per cent, and in Spain it was 2.97 per cent. By contrast, in Germany average inflation was just 1.65 per cent. In other words, on average every year this decade the five countries that make up PIIGS were becoming that little bit less competitive against Germany. The truth is, when Eurozone interest rates fell to 2 per cent earlier this decade, the interest was far too low for the PIIGS. The PIIGS nation used this lower interest rate funding for government spending. The result is very high budget deficits. The budget deficit in Greece rose dramatically near to 13%.

Concerns about Greece's ability to find private investors to roll over its maturing debt will not go away. The spread between Greek ten-year government bonds and German bunds now stands at more than four percentage points. Greece has €12 billion (\$16 billion) of debt to refinance in April and a further €8 billion to refinance in May. Taken together this is equivalent to 8% of the country's GDP. The government has some €13 billion of cash in hand and can probably rely on €12 billion from the IMF. It will probably need to draw on this before long. Although the country can survive this crisis only worry is about where the growth will come from to pay off high interest debt.

### IMPACT OF THE CRISIS

The crux of the problem is for the financial markets and the investment community as a whole, while the recession for much of the world has likely ended or is ending from purely data-based measures, the global economy is still in the doldrums and financial institutions are slowly recapitalizing and healing themselves, but still face a number of credit challenges. According to the Bank of International Settlement, foreign banks' exposure to Greece bonds is being depicted below



A number of European banks such as those in France and Germany have exposure to Greek sovereign debt. Challenges in Greek bonds have a direct impact on those financial institutions. However, due to Greece's size, the distribution of its government debt worldwide is manageable and likely would not be a knockout blow to the recovering financial sector. The same could be said for Portugal and Ireland Bonds.

Italy may also be less of an immediate issue because much of its debt is domestically financed. In addition, its budget deficit stands at just over 5% which is below the average of the EURO standards and much lower than its PIIGS peers. Further, its unemployment rate too is roughly 8%, also below the EURO composite Levels.

Spain, however, could be a very serious issue and preventing contagion to this country should be the European Union and IMF's top priority. Spain is the World's ninth largest economy according to IMF, compared to Ireland (#38), Portugal (#37), Italy (#7), and Greece (#28). Spain has a budget deficit of roughly 12% while unemployment is nearly 20%. Spain's high unemployment is structural in nature due to the country's heavy reliance on the housing sector, so shifting workers that were reliant on labor intensive applications will be a long and painful road ahead. While the US and UK experienced significant busts in the home prices, Spain experienced an even larger bubble based on the house prices/rent ratios. Even after painful housing implosion, this ratio currently suggests that home values in Spain are still 50% above the fair value. One saving grace of the Spain is that its Debt/GDP ratio stands roughly 50%, which considering a very anemic economy – is not bad at all.

Given the potential for Spain to become a much larger problem down the road, policymakers should not treat Greece in isolation as they currently seem intent on doing.

#### **WHAT'S AHEAD?**

There is a high degree of aversion to sovereign default, but history suggests that defaulters can get second chances. A finding by The Economist presented certain findings about the sovereign Defaults. The study found that in recent years, defaulters have been able to re-enter capital markets once restructuring is complete albeit at higher spreads. However, the effect on spreads is short lived illustrating the short memory capital markets have. Nonetheless, the article noted the current global economy, in conjunction with weak global financial institutions, could result in a much more deleterious impact in the event of a PIIGS Crisis.

The only thing that still remains unanswered is: why the things come forward only when the things go out of control? Why the same can't be averted if the European Union remains strict on their restrictions? The restrictions in terms of say budget deficit limit to be followed by the member's state, I think the problem could have been averted. Let's hope the future would not unfold very ugly.