What Do Rising Sovereign Credit Default Swaps Mean?

By Washington's Blog

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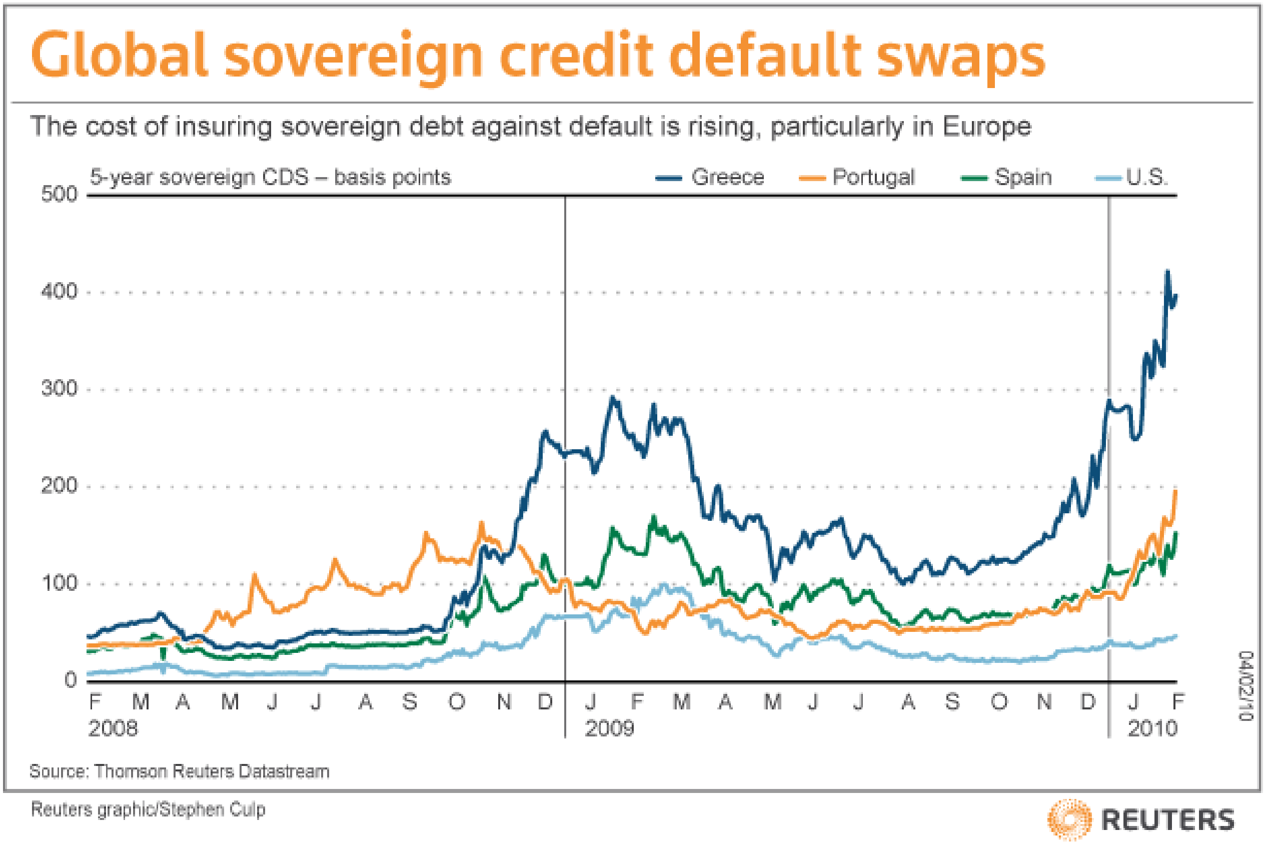
Here are the CDS of Greece, Portugal, Spain and the U.S.:



Reuters graphic/Stephen Culp

Rolfe Winkler argues that – in the short-run – the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) will slash their budgets and get bailed out by the EU.

Simon Johnson thinks that the weakening Euro caused by the PIIGS' woes will hurt American exports (weaker Euro equals stronger dollar), and could lead to problems for leading global banks.

Other commentators fear that the PIIGS' crisis has as much potential as a financial "contagion" as the subprime meltdown and the failure of Lehman.

But for the long-term view, we need a little more perspective. One of the world's leading economic historians – Harvard professor Niall Ferguson – says:

> The economists are ill qualified to analyse the current economic situation since

> they lack the overview of historians such as himself.
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> "There are economic professors in American universities who think they are masters of the universe, but they don't have any historical knowledge. I have never believed that markets are self correcting. No historian could."

Ferguson warns of huge government debts threatening the solvency of entire nations:

> "The idea that countries don't go bust is a joke… The debt trap may be about to spring … for countries that have created large stimulus packages in order to stimulate their economies."

But whether or not large nations actually go bankrupt, one thing is clear . . . Larry Summers, Ben Bernanke, Tim Geithner and their foreign counterparts have failed.

As I [noted] in December 2008:

> BIS [the Bank of International Settlements – the "Central Banks' Central Bank] points out in a new report that the bank rescue packages have transferred significant risks onto government balance sheets, which is reflected in the corresponding widening of sovereign credit default swaps:
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>> The scope and magnitude of the bank rescue packages also meant that significant risks had been transferred onto government balance sheets. This was particularly apparent in the market for CDS referencing sovereigns involved either in large individual bank rescues or in broad-based support packages for the financial sector, including the United States. While such CDS were thinly traded prior to the announced rescue packages, spreads widened suddenly on increased demand for credit protection, while corresponding financial sector spreads tightened.
>
> In other words, by assuming huge portions of the risk from banks trading in toxic derivatives, and by spending trillions that they don't have, central banks have put their countries at risk from default.

Nothing has changed. As former chief Merrill Lynch economist David Rosenberg [writes] this week:

> First the governments bail out the banks who were (are) basically insolvent. Then these governments, especially in Europe, see their balance sheets explode and face escalating concerns over sovereign default. The IMF now predicts that the government debt-to-GDP ratio in the G20 nations will explode to 118% by 2014 from pre-crisis levels of around 80%.
>
> Now, the ball is put back onto the banks because many have exposure to the areas of Europe that are facing substantial fiscal problems right now. According to the Wall Street Journal, U.K. banks have $193 billion of exposure to Ireland. German banks have the same amount of exposure and an additional $240 billion to Spain. Many international bond mutual funds also have sizeable exposure to sovereign debt of Portugal, Ireland, Greece and Spain as well.

Contagion risks are back. Stay defensive and expect to see heightened volatility.

In a nutshell, toxic assets have basically been swept under the rug in the hopes that we will outgrow the problem. Leverage ratios across every level of society are still reaching unprecedented levels as the public sector sacrifices the sanctity of its balance sheet in its quest to stabilize the dubious financial position of the household and banking sectors in many parts of the world.

Whatever bad assets have been resolved have almost entirely been placed on the books of governments and central banks, which now have their own particular set of risks, as we have witnessed very recently in places like Dubai, Mexico, and Greece, not to mention at the state and local government level in the United States. We simply have not seen a reduction in the percentage of properties with mortgages that are “under water”, hence the FDIC has identified 7% of banking sector assets ($850 billion) that are in “trouble”, so how can it possibly be that the financial system is anywhere close to some stable equilibrium?

When accurately measured, including the shadow inventory from bank foreclosures, there is still nearly two year’s worth of unsold housing inventory in the United States, and commercial vacancy rates are poised to reach unprecedented highs, and this excess supply is bound to unleash another round of price deflation and debt defaults this year. The balance sheets of governments are rapidly in decline across a broad continuum, and it is particularly questionable as to whether Europe is in sound enough financial shape to weather another banking-related storm.

The global economy is set to cool off. Not only is China and India warding off inflation with credit tightening measures but most of the fiscal and monetary stimulus thrust in the U.S.A. and Canada is behind us as well. And, the fiscal tourniquet is about to be applied in many parts of Europe, especially the PIIGS (referring to Portugal, Ireland, Italy, Greece and Spain — these countries account for a nontrivial 37% of Eurozone GDP). Greece’s GDP has already contracted by 3.0% YoY, as of Q4, and is expected to contract 1.1% in 2010 and 0.3% in 2011 as a 13% deficit-to-GDP ratio is sliced from 13% to 3% (assuming this fiscal goal can be achieved politically). Portugal has a 9.2% deficit-to-GDP ratio that is in need of repair and Spain has a deficit ratio that is even worse, at 11.4% of GDP.

The bottom line is that even if the fiscally-challenged countries of Europe do not end up defaulting, or leaving the Union, the reality is that they will have to take draconian measures to meet their financial obligations. Devaluation was the answer in the past in Greece but it cannot rely on that quick fix this time around without leaving EMU and if it did, then that could make it even harder to service its Euro-denominated debts — at least not without a restructuring. And, if Greece did attempt at a debt restructuring, rest assured that Italy, Spain, Portugal and Ireland would be next — we are talking about a combined $2 trillion of potential sovereign debt restructuring that would more than triple the $600 billion direct cost of the Lehman bankruptcy.

This poses a hurdle over global growth prospects at a time when Asia will feel the pinch from the credit-tightening moves in China and India. And heightened risk premia will also exert a dampening global dynamic of their own in terms of economic decision-making by businesses and households alike. The intense sovereign risk concerns are not limited to Europe either. In the U.S.A. we saw CDS spreads widen out to their highest levels since the equity markets were coming off their lows last April. According to the FT, the Markit iTrax SivX [sic] index of CDS on 15 western European sovereign credits rose above 100bps on Friday for the first time ever.

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