Aureus Asset Management, LLC
Europe's Sovereign Debt/Banking Crisis

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Introduction

Europe's sovereign debt/banking crisis will not be finally resolved until the politicians decide that it's better to face the consequences of a true solution, than to continue to postpone. To date, all that has happened is delaying the day of reckoning, through granting loans of enormous size to countries which have no realistic hope of ever repaying. The purity of the European Central Bank has been compromised by its purchases, sometimes being the sole purchaser, of southern European debt issues. The head of the German bank has resigned instead of placing his name in contention to be head of the ECB, after apparently determining that his insistence on facing the problem forthrightly would not be countenanced by politicians at this time.

Yet there are Europeans who know exactly how to define the problem and how to solve it. As an example, here are passages from a column in the Financial Times of Feb 7, 2011, written by Wolfgang Munchau:

"A more serious approach to crisis resolution would start with a comprehensive European Union-wide plan to recapitalize and shrink the banking sector. Then, you would restructure whatever sovereign debt needs restructuring. Of the two critical issues of crisis resolution—bank recapitalization and sovereign debt restructuring—we are regressing on the first and possibly underestimating the consequences of the second. Why is the EU so reluctant to solve the crisis, given what is at stake? There are two reasons. The first is that national regulators focus on their own banking sector's competitiveness. The second is that it would be very costly. Once we start resolving the crisis for real, it will get expensive. Sovereign debt restructuring will mean big losses for banks and insurance groups. Genuine crisis resolution is also politically risky. It will require a massive loss of national sovereignty and deep incisions in national wage bargaining systems. No country, not even Greece, has yet prepared its public for what would undoubtedly constitute the biggest change in social policy in more than a century".

Why is the problem so intractable? Because it is very, very big. Let's examine how much debt, in all forms, comprises the balance sheet of four European nations:

I. Sector composition of debt across countries.

Country	**Debt as a % of GDP**				**Total debt**
	Gov't.	Household	Non-financial Bus.	Financial	
Spain	63%	86%	139%	103%	391%
Portugal	83	96	138	57	374%
Ireland	94	88	67	63	312%
Greece	131	50	54	69	304%
U.S.	84	99	80	106	369%

Looking at total debt, it is clear that overall levels are not out of line with those of the US. However, the US has the huge advantage of having the world's reserve currency, as well as a much bigger and more diversified economy.

The southern European countries plus Ireland have economies all in deep trouble, with massive unemployment, large current account deficits, and little if any hopes for a decent economic recovery. A major restructuring of these countries' debts seems the only practical solution, or else the populace of each country is doomed to years of very high taxes and little growth, all to pay back creditors who should have known better.

The complicating factor is that the principal creditors are many European banks, including virtually all the major banks of both France and Germany, which hold vast amounts of the sovereign debt of the four countries in trouble. A realistic writedown of from 30% to 60% of that debt, depending on the country, will force a recapitalization of all these banks, whose balance sheets cannot stand large write-offs of sovereign debt without infusion of substantial new capital. Probably the European states themselves will have to come up with much of the new capital for the banking system, as it appears unlikely that the private market could absorb the size of these writedowns all at once.

European banking systems are vastly larger, as a percent of GDP, than in the US, a fact which may not be sufficiently understood. Examine the following table:

II. Oversized banking systems

Country	*Total Bank Assets as % GDP*
Greece	225%
Ireland	500%
Portugal	320%
Spain	350%
US	85%

The amount of exposure to each country's sovereign debt is also frightening:

III. Foreign bank exposure to European peripherals

Exposure to:	German banks	French banks	UK banks	US banks
Greece	$37 billion	$57 billion	$12 billion	$7 billion
Ireland	$138 b	$44 b	$148 b	$57 b
Portugal	$37 b	$41 b	$22 b	$3 b
Spain	$182 b	$164 b	$105 b	$52 b
Total	$394 billion	$306 billion	$287 billion	$119 billion

IV. Conclusion

The combinations of very poor economic growth, poor current accounts, and huge debts coming due (many of which need to be refinanced this year or next) make it very likely that Greece, Ireland, and Portugal will have to default, and force a major restructuring of their debts. Spain is a crucial question mark. While Spain's public debt is not as large as the others, its total debt burden is. Its unemployment is 20% and growing and its economic growth outlook is poor.

The French, German and UK banks look to be in line for major infusion of public funds, if the European debt problem is resolved by default, as these banks hold hundreds of billions of sovereign debt obligations.

Only the timing of these developments is uncertain. Politicians want to make the problem go away by postponing it, through advances of more debt via the ECB to the affected countries. All this does is to make the problem more difficult.

When the politicians do face up to this challenge and do the right thing, there will probably be two reactions. First, there will be a shock, as the size of the problem is driven home. After the initial shock, however, many people will come round to the point of view that this is what should have happened in the first place. As that attitude takes hold, the euro should eventually strengthen and the European economies may finally be more competitive and healthier.