

In US debt row, hints of emerging-economy crises

REUTERS, Washington

Debt default. A ratings downgrade. Political deadlock. Such terms, once associated primarily with the developing world, now abound in the mighty United States.

As the US Congress flirts with the once-unthinkable prospect of not paying the country's bills, the heated battle over a usually routine vote to lift the country's debt ceiling is dealing another blow to America's image.

The global financial crisis, which was rooted in poor regulation of the US housing and banking sectors, already tarnished perceptions of the United States overseas.

For political economy experts who have spent their careers focused on the emerging world, Washington's protracted debt stand-off is all too reminiscent of the divisions more typical of developing-country politics.

"We attend a lot of meetings with Latin Americans and we used to complain to them about the problems they had, and now they like to say to us: 'That sounds just like the US'," said Peter Hakim, head of the Inter-American Dialogue, a policy group in Washington.

"What's really shocking is the inability to reach agreement. All of a sudden the US is a democracy that is unable to find a compromise. We're polarised."

That sort of polarisation is common in the developing world. The United States was often a critic of institutional disarray in places such as Brazil, where a multitude of parties makes it difficult to enact legislation, or Mexico, where the opposite problem -- long-standing one-party rule -- stifled political choice.

Yet the stalemate now facing the US two-party system demonstrates the challenges of the divided government Americans voted for last November.

Given that the United States is home to not only the world's largest economy but also its most liquid and safe debt market, the repercussions of a US financial meltdown are potentially much larger than a more contained emerging-markets crisis.

British Business Secretary Vince Cable told BBC television on Sunday that "right-wing nutters" in the US Congress were holding up a deal to prevent a catastrophic default, posing a greater threat to the global financial system than the euro zone, which has been grappling with a debt crisis of its own.

Argentina's President Cristina Fernandez, whose own country defaulted on about \$100 billion in debt a decade ago, asked last week: "When did the American dream become a nightmare?"

When advising the United States on how to



Businessmen walk past a bank's signboard advertising its foreign currency exchange centre in front of the bank in Seoul.

REUTERS/FILE

deal with the budget crisis, ratings agency Moody's last week suggested the country eliminate the debt ceiling to prevent repeats of the kind of uncertainty now gripping financial markets.

Instead it suggested following the example of Chile, where increases in debt are constrained but not technically limited.

Fast-growing countries in Latin America, including Chile and Brazil, achieved a more sustained growth path in part due to reforms aimed at reducing their debt loads and reining in budget deficits.

The push from Republican leaders for sharp cuts in US government spending, which many economists say would hurt a fragile recovery, has made the rating agencies a driving force for policy. They had come under fire for giving top-notch grades to shoddy real estate securities, contributing to the financial meltdown of 2007-08.

Ratings agencies played a central role in the emerging-market debt crises in Russia, Asia and Latin America in the late 1990s. Back then they were also criticised as too late to downgrade countries with questionable credit records.

If the United States is downgraded, interest rates could rise, risking a new recession. Some Wall Street economists say the recovery is already being hampered as the threat of a debt default deals a further blow to consumer confidence.

Another damaging consequence of the debt limit scuffle has been to shift the discussion away from doing more to bring down a 9.2 percent jobless rate to a debate over spending cuts that will most likely put a damper on economic growth.

Investors, who long brushed off the prospect of an outright default as highly unlikely, are increas-

ingly concerned and shocked that the politicians in Washington have allowed the crisis to get this far.

"The extent of political dysfunctionality will stun many, especially at a time when America needs unity and common purpose in DC to also address high unemployment and other challenges," said Mohamed El-Erian, co-chief investment officer of the mega bond fund PIMCO, who writes columns for Reuters.

Haag Sherman, managing partner at Salient Partners, an investment firm in Houston, Texas, said the angry tone of US politics harked back to the early days of the Republic, when the United States really was a developing nation.

"We were an emerging market then, and you have some of the hallmarks of an emerging economy today: increasing concentration of wealth, an entrenchment of the political class," he said.

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Greek rescue bizarrely increases its debts

HUGO DIXON

Listen to the politicians and one might think that Greece's debts will fall as a result of last week's provisional rescue by euro zone leaders and private-sector creditors. In fact, they go up. Athens' borrowings will increase by 31 billion euros under the rescue scheme, according to an analysis by Reuters Breakingviews. This increase, equivalent to 14 percent of GDP, will push the country's estimated peak debt/GDP ratio next year to 179 percent.

This bizarre result comes because of the way the different elements of the fearfully complex rescue plan interact. Greece will need to borrow extra funds to enhance the creditworthiness of the new bonds it will provide the private sector. It will also need to inject capital into its own banks. These extra borrowings amount to 55 billion euros and will more than outweigh the reduction in Greece's debts that comes as a result of haircuts to be agreed by private-sector creditors and a planned buyback of debt at a discount to its face value.

The Breakingviews analysis is at variance with comments made by Nicolas Sarkozy, France's president. He said after the July 21 summit of euro zone leaders that Greece's debts would fall by 24 percentage points of GDP. This was because he ignored the costs of "credit enhancement" and bank recapitalisation. He also included in the debt reduction 12 percentage points of GDP coming from the fact that Athens will be paying low interest rates on its official loans. While this will definitely improve the country's debt sustainability, the benefit (under Sarkozy's maths) will be spread over 10 years.

The euro zone leaders agreed to provide 109 billion euros in extra funds to Greece. This money will be supplied by the European Financial Stability Facility (EFSF), the euro zone's bailout fund.

At the same time, private-sector creditors, under the auspices of the Institute of International Finance (IIF), plan to contribute a gross 54 billion euros to Greece's funding needs by mid-2014 and a further 81 billion euros between mid-2014 and end-2020 - or 135 billion in total. This

contribution will come by swapping old bonds for new Greek bonds, or by rolling over old bonds into new bonds when they mature.

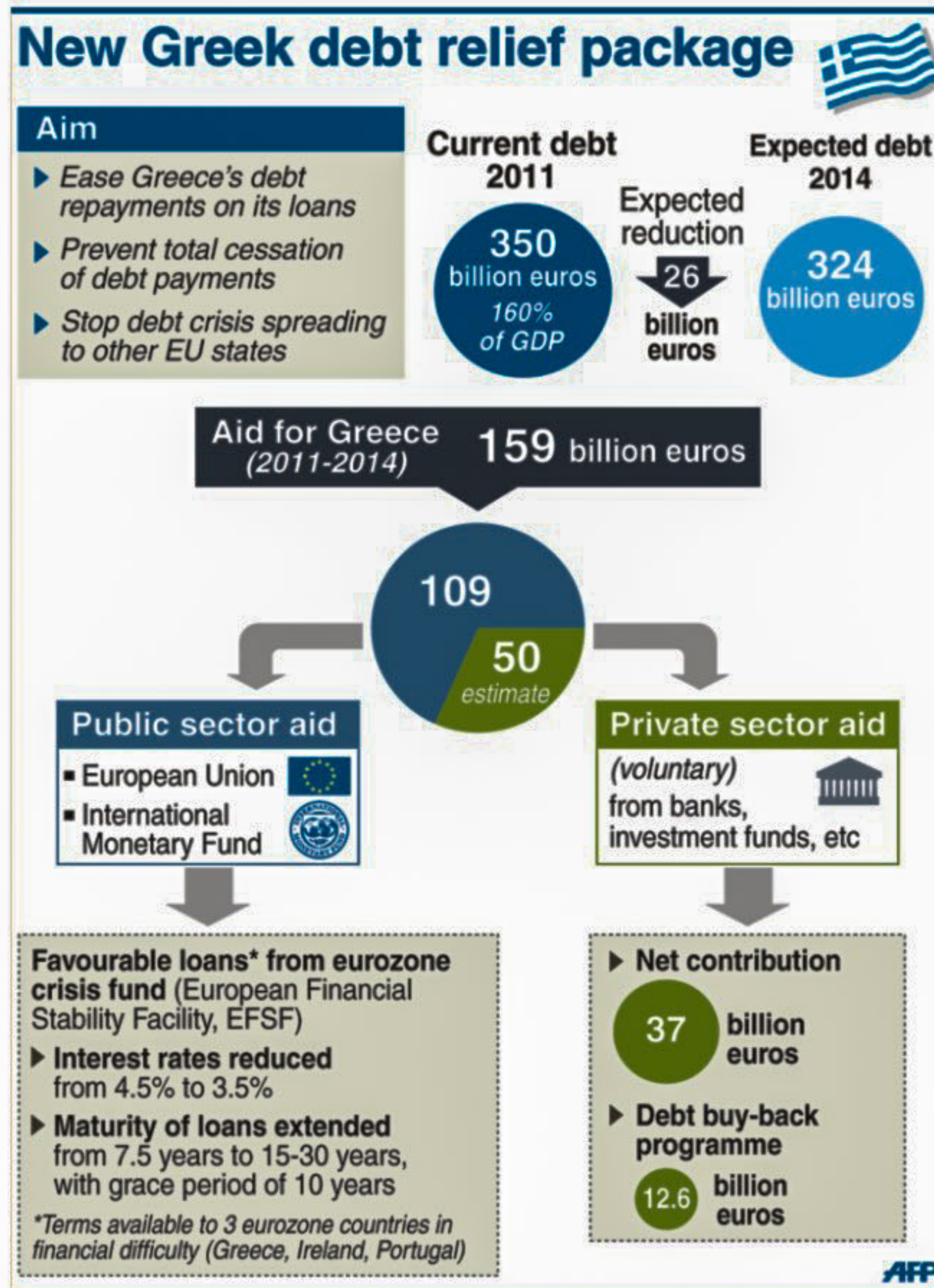
The IIF has proposed four "bond swap/rollover" options, two of which would require creditors to take an immediate 20 percent haircut on the value of their bonds. The other options don't require haircuts but pay lower interest rates.

All this might seem extremely attractive for Greece if it wasn't for the fine print of the IIF scheme. This requires Greece to provide collateral to partly guarantee the new loans, in a so-called "credit enhancement". The mechanism for doing this isn't the same for all the options. But, to guarantee the new 30-year bonds, Athens would purchase 30-year zero-coupon AAA-rated bonds. A zero-coupon bond is one that pays no interest. With such collateral, the creditors would be sure that they would at least get their money back at the end of the period -- even if Greece couldn't pay the interest on the loans.

Zero-coupon bonds are not as expensive to buy as normal bonds. But these 30-year instruments will still cost just over 30 percent of their face value. Greece will therefore need to find 42 billion euros to finance credit enhancements for the 135 billion euros of bonds covered in the IIF's scheme, according to a paper presented to the euro zone leaders at their summit. Of this, 35 billion would need to be found before mid-2014. The EFSF will lend Greece that money and that is the main reason why Athens' debts will rise rather than fall.

The remaining 7 billion euros of the 42 billion euros credit enhancement is expected to be required after mid-2014 because some of the debt that would be rolled over into new bonds wouldn't come due until then. Greece is expected to find that cash itself.

In addition, Greece's debts will increase because it will have to recapitalise its banks, which have large holdings of their own government's bonds. The paper presented to the euro zone leaders earmarked 20 billion euros for this purpose. Greece will borrow this



money from the EFSF too.

Two parts of the programme will genuinely cut Greece's debts. The first is the bond swap/rollover mentioned above. The IIF assumes that half of the creditors taking part will choose an option requiring a 20 percent haircut and the rest will go for no haircut. If 135 billion euros of old debt is restructured in this way, Athens' debt will fall by 13.5 billion euros.

But not all of this will happen immediately -- in the same way that not all the cost of credit enhancement will fall due immediately. If one assumes that the debt reduction works to the same

timetable as the credit enhancement, this part of the programme would cut Greece's borrowing by 11.25 billion euros by mid-2014.

The other part of the programme that would cut Athens' debts is a planned bond buyback. The paper presented to leaders earmarked 20 billion euros for this purpose. It assumed that Greece would be able to buy back debt in the market at 61.4 percent of face value. That would be a premium of 9.54 cents to its market value. With these assumptions, Greece would be able to buy bonds with a face value of 32.6 billion euros. Although it

would have to borrow the 20 billion euros from the EFSF, its debts would decline by 12.6 billion euros.

This buyback scheme has also been pushed by the IIF, which argues that a premium to market prices would be required to persuade bondholders to part with their paper. It also believes that this buyback is most likely to appeal to holders of very long-dated Greek bonds, which will not be involved in the "bond swap" and which trade at a particularly deep discount to their face value.

To calculate the net effect of all this on Greece's debt, it is necessary to add the 35 billion euro cost of the credit enhancement and the 20 billion euros for bank recapitalisation and then subtract the 11.25 billion benefit from the bond swap/rollover and the 12.6 billion reduction from the buyback. This sum comes to 31 billion euros.

The IMF had already earmarked 16 billion euros for bank recapitalisation in its review of Greece earlier this month. That means only 15 billion euros of Athens' debt increase is unanticipated. The IMF also forecast that the country's debt/GDP ratio would peak next year at 172 percent of GDP. To calculate a new debt/GDP ratio, therefore, it is only necessary to add the unanticipated extra debt. That is what is done in the Breakingviews analysis to produce a new figure of 179 percent.

It could be argued that this calculation ignores the fact that the 55 billion euros pumped into credit enhancement and bank recapitalisation haven't vanished. They are assets that will continue to sit on the Greek state's balance sheet. While that is true, the IMF's convention is to look at gross debt. There's a good reason for this. Money sunk into the banks as equity can't be quickly redeployed to pay Athens' debts. And what about the cash tied up in credit enhancement? That's an asset that Greece won't be able to touch for 30 years and won't pay a cent of interest in the intervening period.

The author is a Reuters Breakingviews columnist. The opinions expressed are his own.

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