

# Themes on the Global Markets™

## Another Year of Living Dangerously The Return of Sovereign Risk

By Adolfo Laurenti, deputy chief economist

The global economy enters 2010 with hopes for recovery. Growth is gaining steam in Far East Asia, led by a re-accelerating Chinese economy. Industrialized countries, both in North America and in Europe, are showing signs of stabilization and resilience. Financial markets are healing, too: the equity rally since March 2009 injected some optimism among investors, while the appetite for fixed income remains robust.

Yet, new risks are rising on the horizon. In particular, the massive government actions undertaken around the world to counter the economic crisis have undermined the fiscal soundness of several countries. Risk aversion may have abated, but when it comes to asset quality, investors remain very selective. A buyers' market in government bonds is forcing some countries to perform a balancing act between expansionary fiscal policies and the need to rein in spending. Not surprisingly, this squaring of the circle is a tough challenge for nations with weaker

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macroeconomic fundamentals or greater exposure to external imbalances (*see Chart 1*). Political populism, on the rise in several Western democracies, further complicates sound budget policies at the time when unemployment is the major concern for elected officials.

In this report, we look at some recent cases of strain on sovereign risk in Iceland, Dubai and Greece. There are several lessons to be learned from these countries about the quality of governance and the risks of globalized financial markets. And there are important insights to be gained for dollar and the outlook for U.S. domestic interest rates.

### Early warnings: Iceland and Dubai

To many, the collapse of the banking system in the small Nordic country of Iceland in late 2008 was a sideshow in a global financial crisis whose epicenters were in London and New York. The Icelandic situation was somewhat unique, considering that each of the three major, local banks carried a balance sheet greater than the national GDP of the country, with heavy exposure to the tumbling real estate market in the United Kingdom.

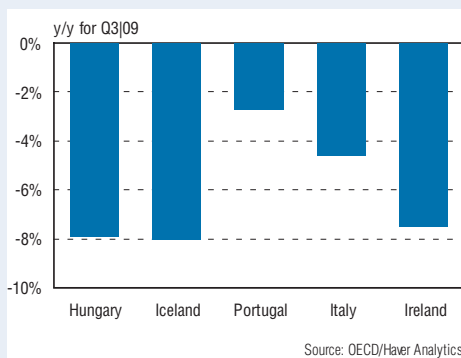
It took a \$5.1 billion bailout, arranged by the International Monetary Fund (IMF), to backstop the local government. The size of the intervention, albeit contained in absolute terms at a time when losses

amounted to trillions of dollars around the globe, was huge in relative terms, accounting for almost half of Iceland's GDP (at \$11 billion, the economy of Iceland is about as big as the GDP of Kalamazoo, Michigan).

And the bailout, while restoring some order in the country, could not prevent a severe contraction, which continues to this day.

In Dubai, matters were different. There, the crisis was not triggered by one sector, but by one company—the government-owned conglomerate, Dubai World. Not unlike Freddie Mac and Fannie Mae in the U.S., Dubai World was in all effects a private corporation which was widely perceived as being guaranteed by the local authorities. Operating like a sovereign equity fund, the company used leverage to buy concentrated stakes in business ventures—illiquid by nature. Once sources for funding dried up, Dubai World failed to rollover its debt in November 2009, and was left with default as the only option. Authorities in Dubai and at the federal level in the United Arab Emirates (UAE) played a game of chicken about a possible bailout, which left investors confused about what the actual outcome might be. Eventually, the UAE federal government and the fiscally conservative and financially sound Abu Dhabi blinked, and Dubai received a much needed infusion of several billion dollars

CHART 1  
Decline in GDP



that will permit the orderly restructuring of Dubai World debt.

### Lessons learned...or not?

There are three lessons that can be learned from the events in Iceland and Dubai.

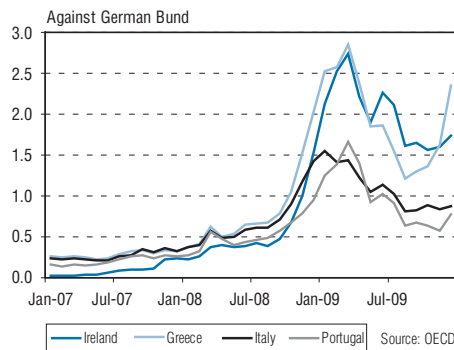
- A sound government budget position does not necessarily translate into sound macroeconomic fundamentals. Public finances were fine, both in Iceland and in Dubai, yet government coffers were out-matched in both cases by the unraveling of gigantic financial institutions, either private or semi-public in nature.
- Financial crises hit fast; in both cases, it took just a few days for the financial architecture to collapse, and take with it the “real economy;” no longer just the financial sector. At that point, policymakers faced financial, economic and political hurdles nearly impossible to surmount.
- Moral hazard matters. Too-big-to-fail is a reality that is priced into the valuation of assets and institutions of which governments cannot let go. Global investors take government guarantees seriously, yet in too many cases, policymakers fail to rein in risk-taking by large institutions with easy access to cheap funding.

Based on these precedents, we would expect other countries to move aggressively to preempt the chances of another sovereign risk fiasco. Included in the contingency plans we'd like to see: an aggressive oversight of institutions posing systemic risk, a credible commitment against implicit government guarantees to financial institutions, a firewall between public finances and risky enterprises, and mechanisms for the prompt resolution of failing companies. Yet, other than vague statements, very little progress seems to be taking place on this front—abroad as well as in the U.S.

### A Greek tragedy?

Greece differs from Iceland and Dubai because it represents a more traditional case of a country running into trouble for its burgeoning external debt. In another sense,

CHART 2  
10yr Government Bond Spreads



though, Greece matters because it epitomizes the economic woes of several European countries, both in the euro area and recently among members of Central and Eastern Europe.

Greece is also a sad story of missed opportunities. After a few years of buoyant growth ahead of the 2004 Olympic Games, the Greek economy began to falter. Instead of taking prompt corrective actions, a general complacency set in. Fiscal deficits stabilized well above the 3 percent target mandated for partners of the euro, and the resulting public debt rose to 97 percent of GDP. Inflation, while abating, never fell in line with the European averages, causing a decline in the competitiveness of the country. The current account deficit peaked at 14 percent of GDP in 2007, and it remained at elevated levels thereafter. As the credit quality for the country deteriorated, interest rate spreads rose, adding to the cost of servicing the debt. This trend has intensified in recent months, also affecting the spreads of Portugal, Ireland and Italy (see Chart 2).

The “Great Recession” was the final *coup de grâce*. It did not help that a new government, led by the Socialist Party, came into power in October 2009, promising to boost public spending at a time when market sentiments had turned against the idea of additional fiscal loosening. As such, Greece lives on borrowed time. The stability program unveiled last week—long on one-off measures and short on details about future actions—did little to reassure markets.

### New concerns about the eurozone

We continue to believe that the Greek crisis will not be a catalyst for a broader crisis in the eurozone. At the end of the day—and despite the loud rhetoric we've heard in recent weeks—the European partners will step in, providing funds to avert Athens' default. This will come at the cost of further denting the credibility of the European political authorities who, after creating an independent central bank, failed to establish credible rules for a concerted management of fiscal policy. Watch for the euro to be on a roller coaster for the remaining of the year.

### U.S. interest rates and the dollar

Clearly, we do not believe that the situation in the U.S. is anywhere close to any of the aforementioned cases. The risk of default on the federal debt is simply not in the cards. Despite the deterioration in our fiscal position, the U.S. Treasury remains, relatively speaking, in decent shape. If anything, the financial crisis has reinforced the idea of the dollar as a safe haven. Thus, count us out of the lot of gold bugs who have been accumulating bullion at outrageous prices (at \$1100 per ounce and with an economy on the mend, they may want to rethink their portfolio allocation).

For these reasons, we believe that the current dollar rally against the euro is fully justified, and may persist for some time, as the eurozone works through the Greek situation and makes the expected correction in its weakest economies.

Yet, we strongly warn against fiscal complacency. Our budget position has weakened: the deficit rose to almost 10 percent of GDP in 2009, and our debt-to-GDP ratio, which was 36 percent in 2007, will likely stabilize at 65 percent for the next ten years. The real risk is a loss of financial leadership due to a lack of fiscal discipline, which might cost us a ramp-up in long-term rates. This is a more realistic scenario than the one suggested by the doomsayers, and one over which we may have some control. But will Congress have the will to act proactively and decisively?

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