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Partners for Financial Stability
2010 – 2013

Vulnerabilities from the Sovereign Debt Crisis
In
Southeast Europe and Eurasia

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Recap - Stages in the Global Crisis

- Crisis begins more modestly as U.S. sub-prime mortgage problem
- Surprises involving sub-prime mortgages & CDO exposures coupled with lack of transparency (OTC transactions) cause illiquidity in global inter-bank market
- Credit market problems spread; lead to surprise announcements of large losses (negative feedback loops begin)
- Interventions by developed market Governments, Regulators and Central Banks begin (interventions to: stabilize markets & institutions; restore liquidity)
- September 2008 regulatory decisions create “crisis in confidence” – crisis affects markets/institutions and triggers “flight to quality”
 - Impacts developed economies
 - Beginning of impacts on emerging market economies



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Recap - The Stages in the Global Crisis (2)

- Extraordinary measures and global responses needed to stabilize markets and financial intermediaries
 - First wave - liquidity shocks
 - Second wave - solvency shocks (financial sector and real sector)
- Fault lines emerge for sovereign economies
 - Crisis exposes high-risk models for growth - economic reversals
 - Recessions, stabilization packages & stimulus strain sovereign budgets
- Concerns about EuroZone sovereign defaults emerge - stabilization packages needed to facilitate access to debt markets
 - Different paths to the same problem
 - Greece - poor fiscal policies, lack of competitiveness, lack of transparency
 - Ireland - Government stabilization of banking sector impaired fiscal situation



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Summary - The Stages in the Global Crisis (3)

Phase I - Global Financial Crisis

- Credit crunch
- Liquidity gridlock
- Solvency issues exposed - sovereigns, banks, real sector

Phase II - Sovereign Debt Crisis

- Solvency issues
 - Poor fiscal discipline (e.g. Greece)
 - Fiscal stress from moral hazard (e.g. Ireland and potentially Spain)
- Solvency issues lead to illiquidity
- ***Potential contagion and feedback loops***



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SDC Represents Vulnerabilities for Financial Stability

- Presents real vulnerabilities; however, not a foregone conclusion
- Vulnerabilities more pronounced in SEE and Ukraine

Positive Considerations in the Environment:

- Strong vested interests in EuroZone to avoid dislocations triggering loss of confidence (e.g. self-interest)
- Recoveries taking hold in EuroZone growth economies
- IFIs continuing to provide support
- ECB continuing liquidity support to banks (e.g. critical for Greek banks)
- Debt markets, particularly bond markets, have not panicked – absorbing new debt and refinancing existing debt (sovereigns & banks)
- Regulators following cautious path in bank deleveraging



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SDC represents Vulnerabilities for Financial Stability

Concerns in the Environment:

- ***Feedback loops between economies & financial sectors*** (especially SEE)
- Bail-out packages are liquidity stop-gaps – not solutions
- Pricing for debt in problem peripheral economies unsustainable
- Solutions to avoid triggering events are economic ***and*** political
- Inconsistent responses from authorities & plans fail to inspire confidence
- Inflationary pressures raising likelihood of rate increases
- Continental European banks need capital
 - Rationalizing strategies, scaling, and potential for repatriating resources
 - Market responses to upcoming stress test results
- Debt markets, particularly bond markets, control whether crisis will be triggered



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Linkages & Feedback Loops In Economies and Financial Sectors

– **Ownership structures**

- Ownership stakes and funding
- Parent company capital and funding needs
 - Basel III and stress tests increasing demands
- Rationalization of franchises and strategic investments

– **Credit exposures**

- Direct credit exposures to troubled sovereign borrowers
- Indirect exposures (e.g. socially-owned companies)

– **Counterparty exposures**

- Direct counterparty exposure
- Indirect counterparty exposure

– **Trade and capital flows**



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Credible responses and Pre-Emptive Plans Needed

Crisis Response(s) are stop-gap measures

- Responses for short/intermediate-term liquidity challenges
- Buying time to allow sovereign borrowers to fix underlying problems and reassure bondholders; but time is running out
- Absent meaningful reforms, bail-outs funds make problems worse

Sovereign borrowers and systemically-important financial intermediaries must retain confidence (with bondholders, investors and counterparties)

- Process is messy and subject to varying political interests
- Confusing and contradictory messages
- Credibility problems for key parties
- Evolving positions of key parties is potentially problematic
- Reliance on ECB and IFIs (e.g. imperative for Greek banks if Greece reschedules debt)



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Concluding - Overall Thoughts

- Vulnerabilities are real; however, destabilizing events are avoidable
- Central authorities & troubled debtor countries must safeguard credibility
- Politicians and authorities have limited control - bondholders have considerable influence
- Authorities need pre-emptive plan
 - Credibility, certainty and transparency - key attributes for plan to avoid shocks
 - Tactical plans need to complement the over-arching plan (e.g. ECB policies; regulatory requirements, stress tests, monetary policies, etc.)
- Response plan must enable orderly deleveraging while effectively managing problem loans
- Liquidity is fragile, banks relying on central authorities - liquidity measures are misleading / shallow liquidity in local currencies in SEE and Eurasia
- Better coordination needed
 - Among regulators and central authorities
 - With IFIs

Thank You

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