



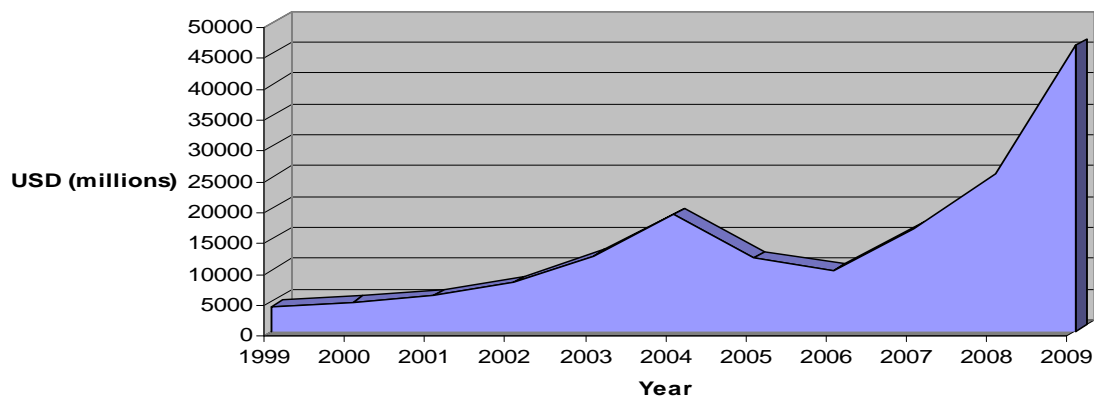
A Bubble in the Euro zone...?

“If someone has €1,000 in debt, he has a problem. If someone has €10 million in debt his bank has a problem.” – Investment Banker

The misfortunes of Greece have once again shot into the media light as the country continues to grapple with its fiscal and debt crisis. As it seeks to combat these issues, members of the European Union (EU) along with the International Monetary Fund (IMF) have agreed upon a loan- guarantee package of USD1 trillion for the region's other debt ridden member states. Greece was allotted a total of USD136 billion, of which it received a disbursement of USD20 billion on 18 May. This injection, though timely, merely scrapes the surface of the underlying problems which could creep in, not only for Greece and the EU, but in the wider global financial markets.

The indebtedness of Greece is not an entirely new problem, and not extraordinary within the EU region. Greece has been operating on budget deficits for a number of years, even prior to its adoption of the Euro as its currency in 2001. However the size of the deficits has ballooned over the last two years as shown in Figure 1. In December 2009, rating agencies Standard and Poor's and Fitch downgraded Greece's credit rating based on the view that measures outlined by Greek authorities to curb its high fiscal deficit, will unlikely lead to a sustainable reduction in its public debt burden. To date, the outlook for the economy remains negative.

Figure 1: Greece's Budget Deficit



As the country edges further toward insolvency, the EU/ IMF financial package was drafted to assist Greece in the refinancing of its debt. The problem with this offer is the EU rules state the 27-member bloc is not obligated to lend money to member states to bridge budget deficits. However, given the interdependence of the EU members, underpinned by its currency, the decision to provide funding was a necessity. To be eligible for the funding, the Greek government needed to curb its deficit spending, having to resort to unpopular austerity plans. Proposals made by the Greek government included increased taxes, freezes on public sector wages, reduced pensions and privatization of some state owned companies. These plans were not well received by the Greek population and have sparked protests across Athens by various labor unions and have the potential to lead to further instability of the economy.

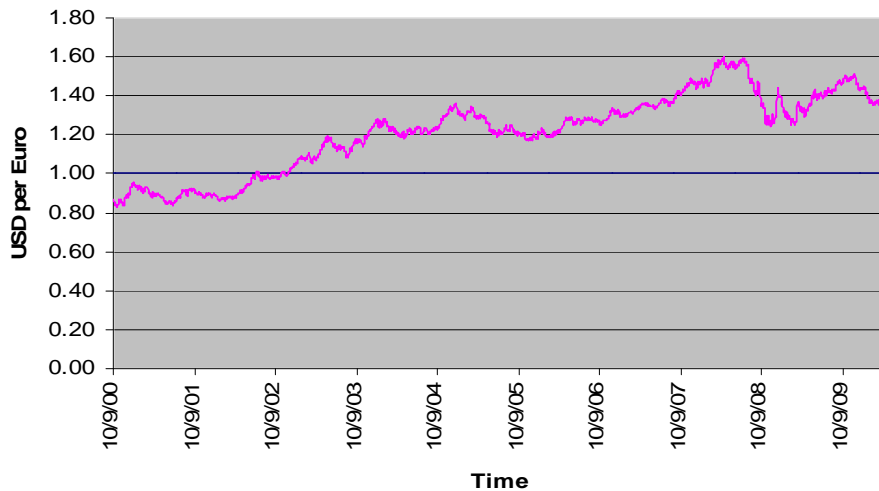
Greece however is not the only problem state within the EU. The countries, termed the "PIIGS" (Portugal, Italy, Ireland, Greece and Spain) all have excessive levels of debt. There is a high probability that these economies are heading towards bankruptcy, with Greece as the front runner. As a measure to mitigate this, the EU has urged these countries and others with large public deficits to curb its spending. Spain has already obliged when its government approved a USD19 billion austerity plan on 20 May. Apart from the unpopularity of these austerity plans, most of the EU economies were gradually exiting the recession brought on by the financial crisis which stemmed from the United States housing market bubble. Ironically, it is the deficit spending which has helped push the EU economies forward. Thus, significant cuts in spending can potentially destabilize these already volatile economies and thrust them back into recession.

As highlighted earlier, the EU is not obligated to finance any of its indebted members. The decision taken to fund Greece's debt was not well received by some other member states. Some argue that the fiscal mismanagement of one EU member should not have to borne by any other. Arguably this is true; however, making reference to the quote above, the debt situation in Greece has spiraled out of control and is now a problem not limited to the borders of Greece. The common currency of the Euro has proven to be the Eurozone's "Achilles Heel" it seems. The strength of 16 nations backing a competitive currency also meant that any weak link in the zone can potentially jeopardize the competitiveness of that currency. This is currently occurring given the situation in Greece. Indeed, the Euro has appreciated by 12% against the US dollar since the start of this year and is currently trading around EUR1.2589 to the greenback.

With the Euro as the second largest reserve currency, many countries around the world and even within the EU would hold bonds denominated in the Euro currency. In fact Greek bonds experienced sharp price declines since the country was downgraded in December 2009. The Greece 2018 Bond was priced at €88.03 and had a yield of 1.61% in May 2009. In April 2010, the price and yield was €62.88 and 6.09% respectively – a 29% change in price. Additionally, the 1 year credit default swap (CDS) for Greece was measured at 123 basis points at the end May 2009 and 1025 basis points at the end of April 2010. This represents a difference of 902 basis points, which indicates the increased risk associated with that country. Thus holders of these securities are now faced with riskier investments, priced low but with a higher yield. The increased yield may be appealing, but the greater risk of default may override this sentiment.

Amid the issue of a depreciating Euro against the US dollar, the dilemma of competitiveness arises. On one end is the Eurozone and on the other it is the United States. Many financial experts have recently been propagating the notion of the Euro and the Dollar moving towards parity, that is, where one USD is equivalent one Euro. Figure 2 shows the relation between the USD and the Euro, which shows its downward trend from the last quarter in 2009 to present.

Figure 2: Exchange Rate Between the US and Euro



- Source: Bloomberg

For the Eurozone, this would boost exports, bringing in some added revenue, especially now when world demand is expanding. On the downside however, depreciation in the currency can hurt the demand for sovereign bonds within the region. This will be extremely critical for countries that are issuing record amounts of debt to help it curtail the recession. In the US, with an appreciating Dollar against the Euro, exports may become less competitive, resulting of possible slow down in export levels. This will be a significant aspect to closely watch as the US aims to boost exports within the coming years. Additionally, with a reduction in exports there is the potential of a slow down in the US, which can be detrimental to an already crawling recovery.

As the debt crisis within the Eurozone continues to unravel, more and more the concern of a depreciating Euro comes to fruition. Analysts believe that it is heading to parity with the Dollar however; they don't foresee it remaining there in the long run. Implications of this new exchange rate is not only restricted to the Eurozone but also has consequences for the global economy. To better deal with this crisis the EU has taken steps to rein in its member states deficit financing. It has also established a bail out fund to assist other countries which may succumb to the same fate as Greece. Although the Greek crisis is far from over, it has been noted that steps are being taken to prevent the possible reoccurrence in Greece, as well as in other countries. The EU is in a very unique situation. The EU is made up of 27 sovereign states unlike the US which is one sovereign. This makes the situation more complex, since the action of one country impacts those of others, as was seen during the last six months. The upcoming months will be crucial for the members of the EU as well as the policy makers, as the member states struggle to contain the pressures contained in the fiscal and external accounts. If managed, they may prevent the region from reverting into an economic recession.

FINANCIAL & ECONOMIC INDICATORS

As at 20 May 2010

Exchange Rate/US\$	Closing Value	Previous Week
Yen	89.68	92.75
Euro	1.25	1.25
Jamaica	89.05	89.18

Commodity Prices	Closing Value	Previous Week
Crude oil (US\$/bbl)	68.01	74.40
Natural Gas (US\$/mmbtu)	4.12	4.26
Gold (US\$/Troy Ounce)	1,182.35	1,232.70

Eurobond Indices (As at 20-05-10)

JP Morgan EMBI+ (Basis points)	340
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	ND

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	9.40	9.40
Trinidad	5.00	5.00
Jamaica	10.50	10.50
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.16	0.16
US 10-Yr Treasury	3.21	3.53
3-month UK Libor	0.70	0.70
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	10.08	10.05
TT 90-day T-Bill	1.16	1.16
Jamaica 90-day T-Bill	9.87	9.73
Barbados 90-day T-Bill	3.24	3.26

Sources: Bloomberg, J.P. Morgan, CMMB Research Center, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados

DISCLAIMER

The information contained in this documentation is for your information only. All information contained in this documentation has been obtained from and is based on sources, including but not limited to, newspaper and magazine articles that CMMB believes to be accurate and reliable. However such information, facts, calculations, methodology, assumptions and estimates contained in this documentation have not been verified by us. All opinions and estimates constitute the Author's judgment as of the date of the documentation which are subject to change; however neither its accuracy and completeness nor the opinions based thereon are guaranteed. As such, no warranty, express or implied, as to the accuracy, timeliness or completeness of this documentation is given or made by CMMB in any form whatsoever. Consequently, CMMB assumes no liability for the accompanying information, which is being provided to you solely for general information.