

EUROPEAN DEBT & THE U.S. MARKETS

Why the crisis has Wall Street stressed.

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It would be wonderful if the U.S. financial markets could “decouple” themselves from what is going on in Greece, Portugal and Spain. Unfortunately, the debt situation in these countries is like a ripple in a pond. The question is, how strong will the ripple ultimately be and will its full force reach our markets?

The problem. Greece, Spain, Portugal, Italy and Ireland are all carrying enormous debts. On May 1, the *New York Times* put up a chart breaking this down: Greece owes \$236 billion, which believe it or not is the *smallest* debt among these five countries. Portugal's debt stands at \$286 billion - and it owes roughly a third of that to Spain. Spain carries around \$1.1 trillion in debt, and its economy is in horrible shape (20% unemployment). According to the Bank for International Settlements, it owes \$220 billion to France and \$238 billion to Germany. Ireland has \$867 billion in debt, with about 40% of that owed to the U.K. and Germany. Italy owes \$1.4 trillion, including \$511 billion to France (almost 20% of France's GDP).¹

After the euro was launched, Greece had access to a whole bunch of cheap debt - and the country used it nonchalantly. In the years since the establishment of the euro, Greece's debt-to-GDP ratio has remained repeatedly above 100%.²

Europe's biggest banks are heavily exposed to these debts, and so are some of ours: names like Citigroup, Bank of America, Goldman Sachs, JPMorgan Chase and Morgan Stanley. In fact, these five banks have \$2.5 trillion of cross-border exposure in the crisis, with Citigroup the most exposed. So you have potential risk to these banks, the euro, and the European and world economy.³

The offer on the table. Fortunately, Greece has the chance to accept a \$146.5 billion bailout from the International Monetary Fund and the European Union in exchange for austerity measures (less government spending and a lower standard of living). This would help Greece avoid default - that is, having to renegotiate its debt and possibly assume more. (As a sovereign nation, Greece cannot go bankrupt.) Many economists think Greece will go into a deep recession (or depression) which could last most of the decade.^{2,4}

The potential ripple. It looks like the bailout will be accepted by Greece and its EU partners. This means some confidence will return and other Eurozone nations with big debts will be slightly less threatened. However, Greece still has a risk of default.

Should Greece default even with the bailout, some major lenders in France and Germany would be hit very hard. They would have to raise capital ratios and reduce the frequency of loans. That would hamper economic growth in France, Germany and in turn across Europe. In coming months, the U.S. and other nations could feel the pinch from such a slowdown.⁴

Keep in mind, Greece only represents about 2% of the Eurozone economy.² In the roughest scenario, Spain or Italy defaults and the shock wave to European banks (and U.S. banks exposed to the debt) is significantly greater. What would happen then? A credit freeze across Europe? Diving stocks? A trashed euro? A flight to gold?

These are merely scenarios, not present realities - but in a nutshell, this is what had Wall Street biting its nails this spring.

So is the bailout truly a solution? It was unpopular throughout the EU, but the right step to take. The move certainly helped defend the stability of the euro; in fact, German Chancellor Angela Merkel and French President Nicholas Sarkozy have jointly pledged to preserve the euro's value.⁵

The worry is that other bailouts will be needed to preserve the fiscal health of other Eurozone nations. We all hope these countries can effectively manage their debt levels, for the sake of the stock market and the economy in our country.

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Citations

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