DOC. N.º 49

The Baseline Scenario
What happened to the global economy and what we can do about it

The Maginot Line Illusion

Posted on June 3, 2010 by Simon Johnson | 44 Comments

By Peter Boone and Simon Johnson

Many commentators suggest Spain is now the euro zone's Maginot line. The argument is clear: Spain, with GDP over $1.3 trillion (8th largest in the world; 5th largest in Europe) and its large outstanding bank and public debt, is simply too big to fail without causing irreparable harm to the euro zone financial system. If we dig in here, the reasoning goes, eurozone market upheavals can be stopped.

Just as Germany did in 1940, in past weeks global market forces circumvented this new Maginot line without serious resistance. The events that shook equity markets were not just in Spain; they were everywhere in the world. The cost of protecting against default on India's largest private bank rose 79BP, or 44%, and the cost of protecting against major Korean banks' default similarly rose 45%. Oil prices collapsed and emerging markets found their access to credit markets dried up. The interest rate for lending between banks in US dollars (LIBOR) shot up, and investors piled funds into their currently perceived "safe-havens" driving down the yields of German, French, and US bonds.

This pattern reflects the core problem facing world markets today. Investors have already begun to extrapolate from eurozone problems to understand that the world remains a highly dangerous place. The latent dangers include our overreliance on rapid Asian growth that might falter, the pressure for sharp fiscal tightening in nations with high deficits (other than in the world's "safe havens"), and highly leveraged banks that continue to own toxic real estate, weak sovereign debt, and other assets. If world financial markets once again decide their risk appetite is again low, there are many unsustainable leveraged institutions and governments that are in for a tough ride.

Spain's role in this possible calamity is more that of a sideshow than a frontline. Spain has a fighting chance for survival without serious economic disruption, but only if the world economy remains at the least benign. To get out of its difficulties, the Spanish government needs to be far more determined than the light approach taken by the Irish and Portuguese (which face far worse problems than Spain).

To be clear, Spain has a better chance of avoiding sovereign and massive bank defaults compared to Greece, which is in intensive care – with a doubtful prognosis and a permanent resource infusion from the European Central Bank. In this regard the announcements in the last few weeks from Spain were helpful, for example when the government chose resolution authority over religious authority in taking legal control of a troubled savings bank (CajaSur) from the Catholic Church.

Spain's savings banks, often owned by local authorities, the church, and other civic groups are generally a bastion of moral hazard due to the implicit belief that no political leader would let the relevant creditors fail. The CajaSur takeover did not impose losses on creditors, but it did establish that the managers of failed banks can at least lose their jobs.

The highly unpopular budget reforms announced by Prime Minister Zapatero further demonstrate some resolve – and the fact they just passed a legislative hurdle is encouraging. According to optimistic forecasts, Spain's budget deficit will fall to 5.3% of GDP next year (although the European Commission still has this projected at 9.8%). If Spain can get anywhere near this level, despite 20% unemployment, then financial markets will probably go easy on them. Spain's high unemployment is partly the result of a more liberalized labor market that made it easier for employers not renew term contracts. This has made Spain one of the worst nations in Europe in terms of employment loss, but it also means jobs could rebound quickly.

So the question is not whether Spain can remain solvent, but rather whether world markets will be patient enough – and risk tolerant enough – for a much wider range of nations to have enough time to make the needed adjustments.

The Achilles heel for Spain, and for others in Europe, are private credit markets – loose banking regulations and (in some countries) lax fiscal policy during the boom of the 2000s have placed serious countries at the mercy of bond markets. We now know the European Central Bank will refinance sovereign debt for a long time, but there are 22 trillion euros of credits provided by the euro zone banking system largely to the private sector (with total eurozone GDP around 9 trillion euros, this makes euroland highly dependent on credit). If the banking system decides it needs to tighten up on risk-taking, some of this credit will be cut off – thus further slowing growth in the region.

The first and greatest cuts under such a scenario would be for debtors in Portugal-Ireland-Italy-Greece-and-Spain (still lumped together by markets). There are 2 trillion euros of external private credits to Spain, Greece, and Portugal alone – any modest attempt to contract this amount will set off a new round of lower asset prices as enterprises and households try to sell off what they can in order to repay loans, while banks march in to foreclose on property and cut their exposures.

In the United States such a credit contraction would be met with the Federal Reserve pouring out liquidity and helping bail out many creditors. This would not solve the underlying problem – and stores up serious moral hazard issues for creditors in the future – but it at least gives time for the debtors to make payments. The US will also remain a safe haven, as least for a while, and that gives a cushion for the government to run budget deficits and avoid fiscal cuts driven by nervous bond markets.

For Europe it is much harder to predict how events will evolve over the same time frame. The recently announced 750bn euro package actually implies that the troubled nations (definitely Greece and Ireland, likely Portugal and perhaps Spain) must make large fiscal cuts. Bond market vigilantes reign supreme if their actions force fiscal cuts – sadly, this is where the eurozone periphery finds itself. At the moment Germany and France are the safe havens. Bond yields in France fell sharply the last two weeks, while Spain's yields rose, and would have increased much more were it not for ECB purchases.

But who is really safe in Europe? With France running an 8% GDP budget deficit (for 2010) and a debt/GDP ratio of 83.6%, should we be confident they are safe while Spain is not (with debt/GDP at

65%)? France's thirty years of budget deficits do not bode well for anyone expecting an immediate strong fiscal response. In many ways Spain appears better placed to take tough actions than France.

If investors decide that risk taking is no longer the right mode, many nations will be in trouble; there may be Maginot Lines but they are worth nothing. If recent market sentiment signals a coming global downturn rather than continued world growth, investors will soon question whether even the safest havens are safe.

An edited version of this article appeared today on the NYT.com's Economix; it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

RELATED

Irish Worries For The Global Economy
In "Commentary"

To Save The Eurozone: $1 trillion, European Central Bank Reform, And A New Head for the IMF
In "Commentary"

Eurozone: The Kitchen Sink Goes In - Now It's All About Solvency
In "Commentary"

This entry was posted in Commentary. Bookmark the permalink.

44 RESPONSES TO "THE MAGINOT LINE ILLUSION"

Ted K | June 3, 2010 at 7:19 am |

I disagree with some of your prescribed answers on Europe, but this is one of your better posts. I'm actually more in line with Hugh Hendry and Jim Rogers style thinking on this. It's not that I don't care about those people, or not *somewhat* sympathetic to their situation. But I don't think dragging things out and giving more Euros (or cash infusions) to corrupt banks helps the situation. It equates to using a second credit card to pay off a maxed out first credit card. **"Money down a rat hole" is the best way to describe Bernanke and the European Central Bank (ECB) handing money to comprehensively corrupt European banks**

Germany is the one country that has shown even a modicum of responsibility here. I have much much much more sympathy for Spain here than Greece because they have shown more fiscal responsibility than Greece. So if Germany wanted to lend a hand to Spain I think it makes more logic than lending a hand to Greece.

In the end I think Europe is going down and going down hard, and if you look at the fact mutual funds such as VGTSX went up 1.8% yesterday it just proves one thing. **Human beings are not always logical and EMH is a load of bullcrap**

Patrice Ayme | June 7, 2010 at 1:57 pm |

Germany has just decided to squeeze some more (retirement there is at 67 versus 60 in France). And it is true that a lot of USA salaries are completely extravagant, both in government and in the private sector. Some are extravagantly high, and many, too low. the extravagantly high, though, ruin public finance.
PA