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FALCON PERSPECTIVES

VIEWPOINT SABINA WEBER SAUSER

March, 2010

PUBLIC DEBT

Many analysts believe that a new wave of the global crisis is about to start. Whereas the first wave was all about the liquidity of the banking sector, investors are now worrying about the solvency of sovereign states. Initially, the governments' stimulus programs saved the global economy. In the meantime however, some countries have turned into problematic cases themselves as their deficits and liabilities are weighing heavily on the economy. National debt levels in many western countries have risen significantly since the breakout of the financial crisis. The absolute numbers are already very impressive; but it really gets frightening if one compares total national debt to gross domestic product (GDP), including the new indebtedness in the next few years.

Greece's debt is making headlines these days, but the problems here are not new. When Greece joined the euro, its public debt already amounted to over 100% of its GDP. But the debt situation in euro land is not any worse than in other western states. According to OECD estimates, US and UK debt levels, expressed as a percentage of GDP, will be higher than in the euro zone by 2011. Hence, the situation is worst for countries that do not only suffer from a banking and a real estate crisis, but whose public debt is deteriorating rapidly, too. In Europe, Spain and the UK are facing above all such an uncomfortable constellation, whereas Greece is not the main problem.

What can countries do to reduce their national debt? In theory, there are the following possibilities:

1. To introduce austerity programs
2. To increase taxes
3. To focus on growth
4. To sell government property
5. Higher inflation
6. National insolvency

Whereas there is concrete savings potential in some countries, above all in Southern Europe, other nations cannot do much more than cutting subsidies and tax relieves. But before taking such drastic measures, one has to ask if they will not neutralize the various stimulus programs which were implemented in the last few months. In fact, the current fragile growth is the result of these very same programs, and there is a real danger that growth could be choked off. Higher taxes directly impact the economic cycle, as they are curbing consumption and investment, increasing the danger not to be able to break out of the debt spiral in the long term. In this context, it needs to be remembered that Japan's fiscal measures, implemented at the end of the nineties, had disastrous impacts on the economy. The growth dynamics, which have set in after most economic downturns in the past, always managed to ease debt worries. But this time around, current economic data leaves little hope for sustainable growth, especially in case rigid austerity programs will be implemented.

Privatization of government property, which took place above all in the nineties of the last century in order to fulfil the so-called Maastricht criteria for the euro introduction, has limited potential to lead the way out of the crisis for Europe, too. What's more, privatizations usually have a one-off effect and budgeted, reliable revenue will not occur any more. Higher inflation is a tempting option for most governments. Numerous examples from the past show that elevated inflation indeed helped to reduce a large part of the national debt. However, such an approach could trigger higher interest rates and the risk that inflation will escalate and cannot be controlled any more. Whereas bankruptcy is a possibility to relieve a private company from the debt spiral, it is not really an option for developed nations even though countries such as Iceland and Greece are currently facing such an uncomfortable situation.

In our view, the process of public debt reduction is only the beginning of a badly needed series of reforms that should include other areas such as for example the increase of the retirement age, the reduction of subsidies, the simplification of labor laws and adjustments in the social systems. But the current fragile state of the global economy is hardly able to digest an immediate downsizing of the stimulus programs on the one hand; on the other hand, such key social issues could be politically highly explosive. Hence, the governments, which are already under pressure, will be able to introduce such necessary reforms only very hesitantly and carefully. In addition, some measures to overhaul public finances have deflationary effects. For that reason, there is limited scope for rising interest rates in the euro zone in the near future. However, risk premiums among the various countries are likely to continue widening.

Not only rapidly rising public deficits, but also the current policy mix is contributing to economist's and investor's nervousness. The uncertainty with regard to government programs and regulation efforts as well as the sustainability with which the new laws and rules are implemented might increase the danger of market volatility. The faster the governments manage to reduce these uncertainties and gain the market's confidence, the more pronounced the growth tendencies could unfold.

Sabina Weber Sauser, CEFA
Head Asset Management and Investment Process

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