Economic Update
Federal Reserve Bank of Dallas
INTERNATIONAL

A Post-Default Euro Area and What It Means for Global Growth

March 21, 2012

Policy developments in the euro area and continued growth in advanced economies have eased uncertainty, lifting near-term global economic prospects. As a result, risk appetite is again driving capital toward emerging economies, which must balance credit growth and currency appreciation against the threat of unsustainable price pressures. The need for structural reform in the euro area and rising energy prices pose downside risks to the modest, yet positive, growth outlook.

Euro Area Steps Back from Brink

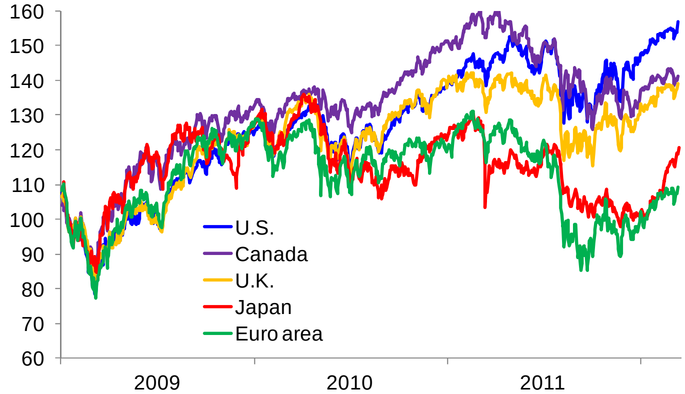
With the injection of nearly €1 trillion of liquidity into the European banking system during December and February through the European Central Bank's longer-term refinancing operations and successful completion of Greece's sovereign debt exchange, euro-area policymakers averted the immediate threat of financial contagion and bolstered confidence in European asset and currency markets. Moreover, the achievement of broad consensus regarding the European Union (EU) fiscal compact represents an attempt by policymakers to prevent one country's fiscal problems from jeopardizing the entire region's prospects.

On Feb. 20, the Eurogroup approved a €130 billion aid package for Greece and set terms for a bond exchange between the European Central Bank and private holders of Greek sovereign debt.[1] This swap represents the largest sovereign debt restructuring in the postwar era—policymakers engineering a reduction of over €200 billion of Greek debt, with the goal of preventing a disorderly default while constructing a viable path for medium-term debt sustainability.

Under the exchange, conducted from Feb. 24 to March 8, holders of 85 percent of all Greek bond debt accepted write-downs of nearly 75 percent on their holdings. Because the Greek government used a collective-action clause to compel the majority of those who did not participate in the swap to accept it, the transaction was classified as a selective default for Greece and triggered further ratings downgrades and payment on credit default swaps, estimated at nearly $3.2 billion.[2] Although some investors feared that a Greek default would reignite a contagion similar to that following the Lehman

Chart 1
Financial Markets in Major Advanced Economies Rally

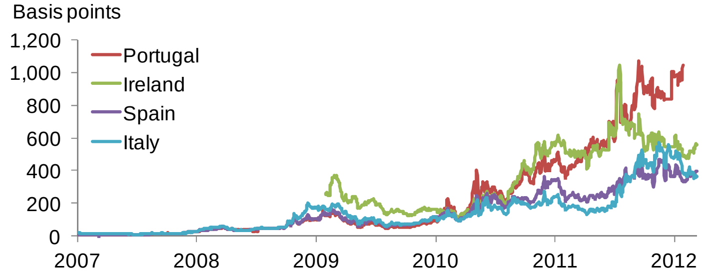
Index, January 2009 = 100



NOTE: Stock market indexes are the Dow Jones industrial average for the U.S, the EURO STOXX 50 for the euro area, the Nikkei 225 for Japan, the FTSE 100 for the U.K. and the S&P/TSX Composite for Canada.
SOURCES: *Wall Street Journal*; Haver Analytics.

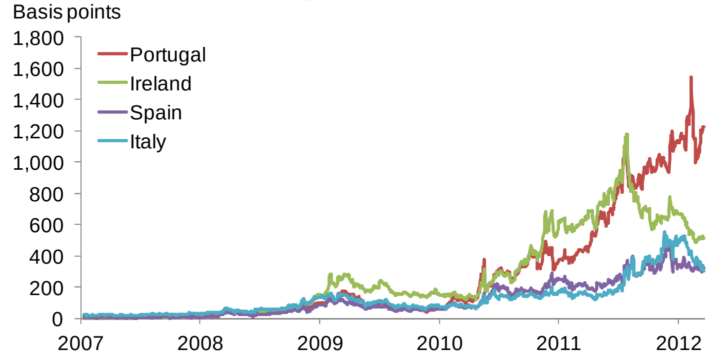
Chart 2
Is Portugal Next?
A. Credit Default Swaps Suggest Break from Pack After Mid-2011

Basis points



B. 10-Year Government Bond Spreads Confirm Rising Risk

Basis points



NOTE: The chart plots credit default swap spreads and 10-year government bond spreads over the German equivalent bond, a risk benchmark.
SOURCES: Bloomberg; Haver Analytics.

Brothers collapse in September 2008, major stock markets have rallied since the start of the year at the prospect that the problems of euro-area peripheral economies would be contained (*Chart 1*).

However, fiscal and financial stability in the region remains fragile. Ireland plans a summer referendum concerning its ratification of the EU fiscal compact; rejecting the agreement would call into question Ireland's eligibility for continued bailout support. Portugal's recession deepened in the fourth quarter of 2011 amid severe public expenditure cuts and suspicions that it would follow Greece into selective default. Spreads of Portuguese government bonds over the German equivalent (a safe-asset benchmark) reflect a rising risk premium (*Chart 2*).

Investors Eye Emerging Economies

A sovereign-debt détente in the euro area, Japan's recovery from fourth-quarter supply-chain disruptions emanating from Thailand and unexpected growth momentum in the U.S. have increased investors' risk tolerance. This shift has prompted a rally in emerging-economy currency markets, with exchange rates against the U.S. dollar up 7 percent on average in major emerging economies since the start of the year (*Chart 3*). Though emerging-economy capital investment has a higher risk–reward tradeoff, the return and level of investment are unstable, and this lack of continuity can produce asset bubbles.

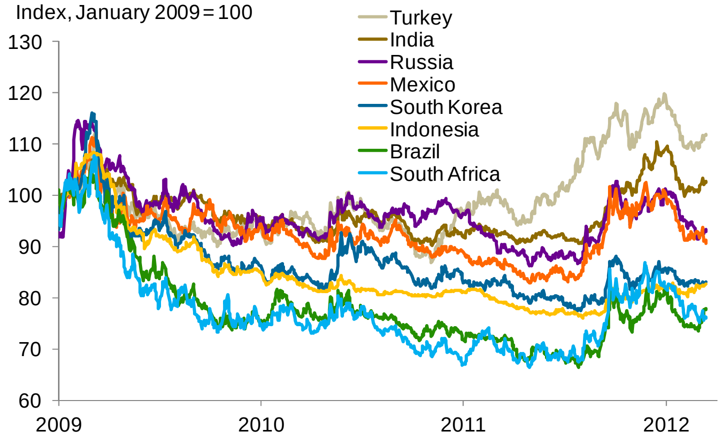
If the global recovery builds momentum and investors continue to shift toward a "risk-on" sentiment, monetary authorities must balance inflation, growth and currency appreciation. Central bankers in Brazil, India, Indonesia and China have lowered policy rates to foster more favorable credit conditions (*Chart 4*). Some emerging economies, such as Brazil, are intervening more directly to ward off appreciation pressures by stemming bond and loan inflows through increased taxes and capital controls.

Material Risks Remain

High energy prices are an effective tax on output and especially affect emerging economies, whose rapidly growing demand is heavily dependent on exports. Since the start of 2011, crude oil prices have jumped 20 percent on the back of geopolitical risk from Iran and supply shocks in South Sudan and Yemen (*Chart 5*). If prices rise further and remain stubbornly high, prospects for the global recovery will likely downshift.

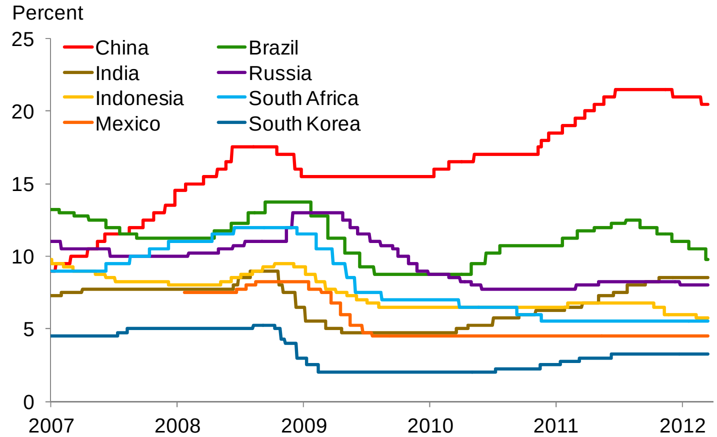
Despite tentative resolution of the Greek debt crisis, the euro area remains a source of uncertainty in the global landscape. Spillover effects that impact emerging economies through the region's reduced import demand will

Chart 3
Dollar Exchange Rates Hint at Appreciation Pressures for Emerging Economies in 2012



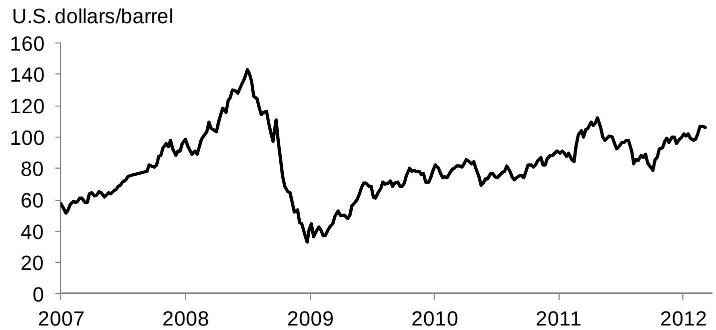
NOTE: Exchange rates are quoted in units of foreign currency per U.S. dollar. An increase in value signals foreign currency depreciation, while a decrease signals appreciation.
SOURCES: *Wall Street Journal*; Haver Analytics.

Chart 4
Central Banks in Major Emerging Economies Ease Rates or Hold Steady



NOTE: The chart plots the reserve-requirement ratio (large depository institutions) for China, the overnight SELIC target rate for Brazil, the repo rate for India, the refinancing rate for Russia, the Bank of Indonesia rate for Indonesia, the average repo rate for South Africa, the target rate for Mexico and the base rate for South Korea.
SOURCES: National central banks; Haver Analytics.

Chart 5
Crude Oil Price Nears Postrecession High



NOTE: The chart plots the weekly end-of-period spot price of West Texas Intermediate crude oil.
SOURCES: *Financial Times*; Haver Analytics.

likely damp global growth prospects, but momentum in global equity markets and renewed interest in emerging-economy investments suggest sentiments have improved compared with late 2011. Moreover, continuing U.S. strength could lead to a more robust outlook.

—Payton Odom

Notes

1. The Eurogroup is composed of the finance ministers of the 17 countries in the euro area and the president of the European Central Bank.
2. A credit default swap (CDS) is a credit derivative contract in which the buyer of the CDS makes a series of payments, or spreads, to the seller in exchange for a payoff if an underlying credit instrument (often a bond) experiences a material credit event or default.

About the Author

Odom is a research analyst in the Research Department of the Federal Reserve Bank of Dallas.