The PREYMA Report

The G20 and Global Capital Markets

Critical Issues and Analysis

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Introduction

At the end of 2010, predictions abounded about the global economy in 2011. The only certainty was the uncertainty in investors' minds as they considered three overarching risks for an apparently slowing global recovery: topping the list is the European sovereign debt crisis, followed by global imbalances and that low interest rates are leading consumers once again to overextend themselves. Although fears of a double dip recession have abated, analysts are seeing cracks in the ability of the emerging markets to pull the rest of the globe out of economic turmoil. The emerging markets are now faced with an overvaluation of their currencies due to low interest rates in developed countries and investors flocking to higher yielding ground. Their exports — as well as the costs of vacation travel — are becoming more expensive, both of which many depend on for revenue.

In the United States, President Barack Obama signed a much disputed tax-cut bill into law in mid December that saw a two-year extension of the Bush-era tax cuts, including keeping the capital gains and dividends tax rates at 15% as well as extending unemployment benefits for 13 months and cutting taxes on payroll for one year. In the spirit of compromise needed from all sides for passage of the bill, he had to abandon his plan to cut taxes only on families making less than $250,000 per year.

AIG announced plans to repay its $21 billion line of credit with the U.S. Federal Reserve with proceeds from the sales of two non-U.S. life insurers. It will next focus on the $49 billion owed to the U.S. Treasury Department. The Treasury will convert its preferred shares into common stock and then sell them into the open market. By March 15, 2011, it plans to divest itself of 92% of all its stock. This comes on the heels of the Treasury's profit of $12 billion on the original $45 billion bailout of Citigroup after it sold the remaining stock it owned in the company for $10.5 billion in one day, which was underwritten by Morgan Stanley. The Treasury also announced an increase in the size of its stock sale of General Motors Corp. to 412.3 million shares.

In Europe, the leaders agreed to re-word the Lisbon Treaty in order to create a permanent crisis safety net called the European Stability Mechanism (ESM). The ESM will come into effect in mid 2013 when the current and temporary European Financial Stability Facility (EFSF), set up by the European Union and the International Monetary Fund (IMF) and worth approximately €750 billion, expires. The treaty is the equivalent of a constitution for the EU. All 27 members must ratify this amendment but because decisions enacting rescue packages must be unanimous, giving any one member the ability to veto, no national referendums are needed. The new text says: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."[1] Some analysts applaud the move, while others feel that it does not address the current issues and are concerned that the current piecemeal approach will lead to greater lack of confidence among investors. Germany also made clear that any future bailouts would require an outline of immediate program spending cuts by that government. No mention was made of creating eurobonds or making bond holders share the risk in the event of a financial crisis.

That same day, the European Central Bank (ECB) announced that it would increase its capital to €10.76 billion, doubling its current size, in response to heightened market volatility and to the severity of the situation in Europe. Eurozone members will provide the increase, which was deemed necessary even after the ECB has bought €71 billion worth of Greek, Irish and Portuguese debt to try to cap the ever increasing yields.

Despite weeks of protests, strikes and opposition from within its own government, Greece passed its austerity budget, which aims to decrease the country's deficit from 9.4% to 7.4% of gross domestic product (GDP) in 2011.

Ireland released an austerity budget, created banking sector reform that was later passed as the Credit Institutions (Stability) Act 2010, which allows the government to impose losses on subordinated

1 James G. Neuger and Jonathan Stearns (2010), "European Leaders Create 2013 Debt Mechanism Amid Debate on Immediate Steps," *Bloomberg*, December 17. <www.bloomberg.com/news/2010-12-16/eu-agrees-to-create-post-2013-crisis-tool-as-bloc-spars-over-current-steps.html>.

debt holder and transfer deposits, and approved the European bailout to the tune of €85 billion. Most of the money will go to recapitalizing the banks to meet the Irish Financial Services Regulatory Authority's new target of 12% core Tier 1 capital, which is needed by the end of February. Nonetheless, Moody's and Fitch credit rating agencies both downgraded the country, with Moody's also downgrading ratings on many of its banks. Anglo Irish Bank will be slowly unwound.

Other countries did not escape unscathed by the contagion in the sovereign debt sell off in Europe as exemplified by Standard & Poor's cutting the debt outlook for Belgium in December.