

Shrinking Euro Union Seen by Creditors Who Cried for Argentina

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Dec. 7 (Bloomberg) -- Nine months before Argentina stopped paying its obligations in 2001, Jonathan Binder sold all his holdings of the nation's bonds, protecting clients from the biggest sovereign default. Now he's betting Greece, Portugal and Spain will restructure debts and leave the euro.

Binder, the former Standard Asset Management banker who is chief investment officer at Consilium Investment Management in Fort Lauderdale, Florida, has been buying credit-default swaps the past year to protect against default by those three nations as well as Italy and Belgium. He's also shorting, or betting against, subordinated bonds of banks in the European Union.

"You will probably see at least one restructuring before the end of the next year," said Binder, whose Emerging Market Absolute Return Fund gained 17.6 percent this year, compared with an average return of 10 percent for those investing in developing nations, according to Barclay Hedge, a Fairfield, Iowa-based firm that tracks hedge funds.

He's got plenty of company. Mohamed El-Erian, whose emerging-market fund at Pacific Investment Management Co. beat its peers in 2001 by avoiding Argentina, expects countries to exit the 16-nation euro zone. Gramercy, a \$2.2 billion investment firm in Greenwich, Connecticut, is buying swaps in Europe to hedge holdings of emerging-market bonds, said Chief Investment Officer Robert Koenigsberger, who dumped Argentine notes more than a year before its default.

'Fiscal Traps'

"The currency rigidities and fiscal traps that bound Argentina in 2001 and the periphery of Europe today are quite similar," Koenigsberger said in e-mailed responses to questions. "We view such hedges as systematic risk protection as opposed to betting on a restructuring per se. The decision will be political, not economic. A purely economic decision would have Greece already in default, and several other nations close behind."

Bonds from Greece and Ireland tumbled since German Chancellor Angela Merkel's Oct. 29 proposal to force debt holders to share the cost of future bailouts. Yields on 10-year Greek notes climbed 116 basis points, or 1.16 percentage points, since Oct. 28 to 11.56 percent, and yields on Irish bonds rose 136 basis points to 8.17 percent. The yields compare with 7.7 percent on dollar bonds sold by Jamaica, which restructured local-currency debt in January and was declared in default by Moody's Investors Service.

Five-year credit-default swaps for Greece jumped 12 basis points to 917 yesterday, above Argentina's 640, making it the second most-expensive credit insurance in the world after Venezuela, according to data compiled by Bloomberg. The contracts pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its agreements.

Rescue Fund

Portugal will likely follow Greece and Ireland in tapping the \$1 trillion EU-International Monetary Fund rescue fund, and some nations will abandon the euro within five years as their economies diverge from Germany, El-Erian, the chief executive officer at Pimco, said in an interview on CNBC on Nov. 30.

“Unless we see something that deals with the balance sheet, expect this contagion to continue to go up,” said El-Erian, whose company runs the world’s largest bond fund in Newport Beach, California. “Be cautious towards the euro.”

El-Erian sold Argentina’s debt in 2000, helping Pimco’s Emerging Markets Bond reap a return of 26.8 percent that year, outperforming 98 percent of its peers, according to data compiled by Bloomberg. El-Erian, 52, wasn’t available to comment, said Mark Porterfield, a Pimco spokesman, in an e-mail.

Dollar Peg

Argentina started struggling to finance its debt in 1999 as the one-to-one peg to a rising dollar squeezed exporters and Brazil, the country’s largest trading partner, devalued the real. Interim President Adolfo Rodriguez Saa announced the default in December 2001, after more than 25 people died in riots that toppled the government over spending cuts and the seizure of retirement savings.

The 50 percent appreciation in the euro against the dollar since 2002 has hurt manufacturers in Greece and Portugal, whose economies grew less than 1 percent a year in the past decade. The shortfall in the current account in the two nations amounted to about 10 percent of gross domestic product, triple the ratio for Argentina in 2000. Portuguese workers staged the country’s first general strike in 22 years last week to protest government austerity measures.

Higher Debt

Greece’s debt totaled 127 percent of GDP in 2009, the second highest in the developed world after Japan, followed by 116 percent in Italy. Argentina’s public debt was 62 percent of its economy in 2001, according to data from the IMF.

The budget deficit in Greece, at 15.4 percent of GDP, is the widest among developed nations, followed by 11 percent in Spain and 9.3 percent in Portugal. Those levels compare with 6.4 percent in Argentina in 2001.

Domingo Cavallo, Argentina’s economy minister who resigned in December 2001 as the country defaulted on \$95 billion, says holders of European government and bank obligations may be forced to take a cut on their investment with the euro intact. The IMF and the EU should buy all the debt of Greece and Ireland at market prices in an “orderly” restructuring, while Portugal and Spain improve their competitiveness through labor and tax reforms, he said in a telephone interview.

‘Rapid Way’

“If they don’t do something additionally in a more rapid way, that may destroy all the governments simply because people in these countries will not stand the deflation and depression accompanied by the fiscal adjustment,” said Cavallo, 64, the chief executive officer of DFC Associate LLC, a consulting firm in Buenos Aires. “There will be a political crisis to come in an extreme way as happened in Argentina.”

Potential defaults haven’t been recognized by foreign- exchange traders. The number of bets that the euro will weaken versus the dollar in the futures market were less than 7 percent of those placed in May when Greece was rescued, data compiled by Washington-based Commodity Futures Trading Commission show.

The EU, IMF, the U.S. and China will do whatever it takes to avoid an Argentina-style default and a breakup of the euro, according to Simon Nocera, a former IMF economist who manages emerging market bonds as the co-founder of Lumen Advisors LLC in San Francisco.

‘Status Quo’

“I don’t think the situation will blow up or someone leaves the euro,” said Nocera, who started cutting his Argentine debt in 2000 when managing \$6 billion at Dresdner RCM Global Investors. “The status quo is of great interest not only to Europe, but also to the U.S. and to China. It’s an entirely different ball game than a simple default in Argentina.”

The European Central Bank has purchased as much as 17 percent of the combined public debt of Greece, Ireland and Portugal, according to a research report by Goldman Sachs Group Inc. on Nov. 29. Chinese President Hu Jintao said on Nov. 8 that his country is “available” to support Portugal.

“After you have a wave of international banking crises, inevitably within a few years, there will be a wave of sovereign debt crises,” said Kenneth Rogoff, a professor at Harvard University who was the chief economist at the IMF from 2001 to 2003, and who predicted “major” bank failures months before Lehman Brothers Holdings Inc. went bankrupt in September 2008. “It’s hard to see an end game that doesn’t involve at least some of the countries restructuring.”

The EU and IMF forecast the Greek economy will shrink 4.2 percent this year and 3 percent in 2011, while Portugal’s may contract 1.4 percent next year because of tighter spending.

“It’s not so much that the Europeans or Germans will stop providing funding for Greece,” said Consilium’s Binder. “Probably Greece will eventually throw up their hands and say: ‘We cannot keep the political pressure of this policy mix because it creates social discontent.’”