230 West Street
Suite 700
Columbus, OH 43215
tel 614.221.1120
fax 614.227.6999
www.gbq.com

Financial Perspective: Can Europe's Problems Slow Construction in the United States?

There is an eerie similarity this summer to the summer of 2008. While the world's financial institutions have healed somewhat from the crisis of that fall, there remain some structural problems that haven't gone away. And like the summer of 2008, there is a financial issue that seems too small and complex to get so concerned about: sovereign debt.

In April the world's stock exchanges discovered again what a relatively small amount of fear could do to investment and stock prices. On all American stock market indexes prices fell back over 10% in just a few weeks. For the better part of a month one country, Greece whose economy is small in comparison with the largest economies, dominated the financial headlines. Ironically, the markets had been hearing about Greece's debt problems for more than six months. During that time experts and heads of state assured us that the concerns were overblown, that Greece's problems were too small, and that even if the nation defaulted it would have little real effect other than unsettling still nervous investors.

Does any of this sound familiar? Remember the reassurances after Bear Stearns imploded? The scoffing at how small a share sub-prime mortgages were? How about the daily denials that (you fill in the blank here) had any liquidity problems?

In truth it's a little early to sound global alarms over the mounting debts of the European Union nations, or even our own national debt, but the ramifications of even the solutions to the sovereign debt issue are sobering. If April stock markets were any indication it would do us all a bit of good to remember how deeply the power of panic affected the real estate and construction industries less than two years ago.

Before we get to the Chicken Little stage it's appropriate to understand the facts of the problem. For Greece, as well as Spain, Portugal, Hungary, Ireland and others, the amount of their government's debt has grown to the point where it matches or exceeds its gross domestic product. That's a problem. Once a nation's debt-to-GDP ratio rises above 70% the cost of servicing the debt – the interest paid the creditors – begins to drag on the nation's growth. At 100% of GDP a very high percentage of the country's tax receipts are going to pay interest alone. That means fewer pennies on the dollar going to services for the citizens or for things that generate higher economic growth and prosperity, like improving infrastructure, aiding businesses or lowering taxes.

Nations with debt that is 90% of GDP or higher can expect growth to be capped at 1.7%, according to a study by economists Carmen Reinhart and Ken Rogoff did of over two hundred years of national data. That rate is less than half of countries with debt ratios of 30% or less.

Besides dragging down economic growth, high sovereign debt begets its own premium for insuring against debt default. When a government has too much debt in the eyes of the market it must pay to protect against default in the form of higher rates. In Western Europe the price to insure against default now exceeds that of protecting North American debt for the first time. By May 7, the cost of default protection in Western Europe had risen to 169 basis points, meaning that the country issuing the debt had to pay $169,000 to buyers of every $10 million in debt. This default protection is usually a premium that reduces the amount of capital a government can raise from a bond issuance.

The solution to a sovereign debt problem obviously, is for that government to reduce its debt obligations. Governments can do that three ways. The first, and most difficult, is for that country's economy to innovate higher productivity and generate exports of new technologies, services or products. The GDP soars and the debt ratio falls. Its citizens have higher incomes and profits, and therefore the government gets higher revenues to repay debts. Government can also contribute by reducing spending at the same time.

Governments can also create inflation of their currency. Sovereign debts can be honored but are repaid in currency that's worth a lot less than when the debt was sold. This is OK for the government but not the borrower. In short order the interest in that government's debt dwindles and higher rates are necessary to attract buyers back. This isn't so good for that government.

Of course the third option is to default on the obligation. For nations with overwhelming obligations, like Greece or Hungary, this may be the only way to make debts go away. For bondholders of their debt the default will mean losses as the borrowing countries negotiate some lower payback. While a short-term fix, the government can expect precious few buyers for their debt in future.

The danger is that once creditors accept partial payment from governments who can't pay they are likely to get similar offers from governments who simply don't wish to pay back their bonds at face value. This would set off a bad chain of events for the capital markets again.

So, what is the likelihood that all of this arcane dealing can stall a real estate deal in your town? The short answer is that finance is one of the least local industries going. Even in the case of Greece or Western Europe today, some of their debt is probably on the balance sheets of most of the lenders doing business in western PA. More to the point, as we saw in 2008 the credit system relies on there being roughly the same number of buyers as sellers, with the fractional difference of opinion about value being how each side sees its profit arising. A crisis in confidence would send buyers to the sidelines and financial instruments of all sorts, whether money market funds or mortgage debt, would be impossible to sell. If European default fear becomes default reality the financial markets could reset the clocks to fall 2008 all over again.

"One thing the financial crisis proved is how really globally interconnected we now are," says Jeffrey Rogers, president and COO of Integra Realty Resources in New York. "Information travels so much faster than even two years ago. Right now the real fear is not any one particular country's default because it's a regional problem.

If Greece defaults the markets can handle it, but let's say Greece, Hungary, Portugal and Spain all default, then we're in for a wild ride."

Rogers pointed out that the problems in the countries vary. "If Greece is risky now, Portugal is maybe half as risky and Spain even less so," he says. He also pointed out that by comparison American governments have taken measures that put them well ahead of European states. "As bad as California's finances are it is still in much better shape than in Europe. They have taken measures already – cutting services, raising taxes – to start balancing their budget. New York is doing the same."

In the final analysis, sovereign debt problems – whether in Europe or in California – matter to construction and real estate development if they dampen the appetite for commercial debt. When residential mortgage defaults melted the credit markets in 2008, all forms of debt became undesirable until risk could be re-priced.

In counterpoint to the headlines of the Eurozone debt problems, the overall debt market has actually continued to improve throughout the spring. Even in the commercial mortgage backed securities market, issuances should reach about $20 billion in 2010, which is about 40% of the historical $50 to $60 billion norms (although only 10% of the high water mark). The danger for real estate and construction is that the financing conduits for development are not normalized yet, and therefore are more vulnerable to heightened fears of not being paid back. That is the kernel of today's problem: there is again enough liquidity to finance the projects being proposed in western PA, for example, but the faith in being paid back isn't fully restored.

"I think we'd have seen more effect by now if these things were going to get out of control like in 2008," says AGC chief economist Kenneth Simonson. "But we seem to still be in a market right now marked by wild swings over secondary events that are taking place in Europe, or bad news from the Gulf."

Simonson has a lot of company among construction industry economists, who acknowledge the potential that a region-wide sovereign debt crisis would chill the credit markets at a time when private financing seems poised to test the waters with real estate again. But he doesn't believe that lenders are leveraged to sovereign debt the way they were to the derivative markets in 2008.

"Of course, I missed how big the subprime problem was too," he joked.