

# Europe takes a step in the right direction

## Economic research note

28 October 2011

- EU leaders have taken a step in the right direction to help bring the sovereign debt and banking crisis to an end. There are four key elements to the package.
- Private holders of Greek debt will take a 50% haircut, with new additional funds to be provided to Greece in an attempt to stabilise debt at 120% of GDP by 2020.
- The EFSF will be 'leveraged' up to €1 trillion by the way of insurance on sovereign bonds and the establishment of an SPV to buy the sovereign bonds of countries facing funding issues.
- The banking system will be strengthened by the coordinated provision of liquidity and an increase in capital requirements.
- The road towards a fiscal union has begun with structural balanced budgets to be legislated and more centralised control over budgets for countries in persistent deficit.
- Markets have responded positively to these developments. However, there still remains significant implementation risk and the economic outlook for the EU remains modest at best. Both these factors could return as negatives for the market in the months ahead.

### Europe takes a step in the right direction

At the Euro Summit held yesterday, the heads of the Euro economies (EU) announced some significant new steps in an effort to resolve the sovereign debt and banking system issues that had been weighing on the EU economies and financial markets globally.

Risk markets have reacted positively to the EU announcements, with European equity markets up around 4%-6% overnight, while currencies such as the EUR (and AUD) have rallied strongly. The impact on the bond markets has, however, been more muted, especially in Italy.

While we see the policy announcements by the EU as a step in the right direction and a welcome development, it is far too early to say that the EU sovereign debt/banking crisis has been solved. Further details on the implementation of the various agreements need to be worked through and as is usually the case, there remains a high risk that a number of countries may not be able or willing to fully implement what they have agreed to do.

For markets, the sharp rally seen overnight will need strong and decisive implementation and action by all the various countries and authorities involved to ensure the rally is maintained. The risks around this seem high.

For the EU economy, the imperative is that financial market conditions settle down enough to improve business and consumer confidence and promote economic growth. With the pace of economic growth slowing in most EU countries and the unemployment rate generally elevated (outside Germany) the true test of the EU plans will be the resumption of economic growth.

This is likely, however, to be very difficult to achieve in an environment of fiscal austerity and ongoing political uncertainty. The pace of credit growth in the EU is also likely to remain very soft as the banks focus on rebuilding balance sheets and raising the required capital. The likely outlook for the EU economy could be, therefore, muted growth at best.

One hope for improvements in economic growth in EU remains on the supply side of the economy. The Euro Summit announcement continued to focus on the need for "structural reforms" to be implemented, particularly in "those Member States who are experiencing tensions in sovereign debt markets."



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In terms of the deal agreed to by the EU leaders, the Euro Summit focused on action on four key fronts:

1. **Greece.** An agreement has been reached to reduce Greece's debt to GDP ratio to an estimated 120% by 2020 by way of a 50% haircut on Greek debt held by private investors. This deal is estimated to reduce Greek debt by €100bn. EU Member states would contribute €30bn to this agreement. In addition, the EU and IMF will put in place a new €100bn financing program for Greece.
2. **Leverage of the EFSF.** The current resources of the European Financial Stability Facility (EFSF) will be leveraged by up to 4-5 times, taking the total capacity of the EFSF to around €1tr. This leverage of the EFSF will come via two mechanisms – through providing insurance on bonds issued by EU members and by the establishment of a Special Purpose Vehicle (SPV) that will be used to purchase sovereign bonds in both primary and secondary markets.
3. **Strengthening the banking system.** This will be achieved via both a coordinated approach to the term-funding needs of the banks and by increasing the capital position of banks to a 9% Core Tier 1 ratio by June 2012.
4. **Fiscal coordination and consolidation.** A move towards fiscal union, especially for those countries under the lending program, will be implemented through stricter controls and centralisation of budget policy.

**Greece**

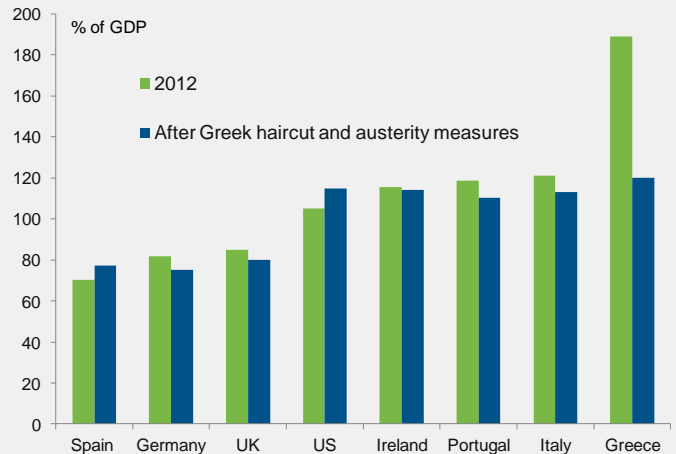
On the package for Greece, the EU leaders noted that monitoring of the implementation of the Greek program will be strengthened and that European Commission will establish “for the duration of the program a monitoring capacity on the ground.” So Greece will have to accept EU authorities in Athens watching over their shoulders. As noted, private sector bond holders have been “invited” to “develop a voluntary bond exchange with a nominal discount of 50% on notional Greek debt.” This program is expected to be finalised by the end of this year “and the exchange of bonds should be implemented at the beginning of 2012.” This haircut is estimated to reduce Greek debt by €100bn.

The EU Member states will contribute €30bn to this package and on that basis the EU and IMF are prepared to provide an additional €100bn in funding for Greece out to 2014, including the amount required for the recapitalisation of Greek banks.

The combination of these commitments is expected to reduce Greek debt to GDP to an estimated 120% by 2020, from a forecast level of above 170% in 2012. The assumptions around the 120% of GDP debt estimate look to be on the optimistic side, especially with the ongoing recession in Greece and, given this, the risk is real that Greek government debt will remain at unsustainably high levels. The chart below highlights the estimated level of government debt both before and after the agreement for Greece.

It is also interesting to note that the EU communiqué reinforces the point that the deal for Greece is unique and that all other EU countries “solemnly reaffirm their inflexible determination to honour fully their own individual signature and all their commitments to sustainable fiscal conditions and structural reform.”

**Government gross debt/GDP**



Source: IMF Fiscal Monitor September 2011. Note 'after' is 2016, for all but Greece (2020) and Italy (2014)

**Leverage of the EFSF**

Two options will be pursued to leverage the EFSF and increase its lending capacity by 4-5 times, taking this to around €1tr.

Firstly, the EFSF will provide first loss insurance on new sovereign bond issues. Purchasing this risk insurance “would be offered to private investors as an option when buying bonds in the primary market.”

Secondly, one or more Special Purpose Vehicles will be created to encourage both public (ie. other central banks and sovereign wealth funds outside of the EU) and private capital into both the primary and secondary sovereign bond markets.

Work on this part of the plan is, however, not yet complete. EU Finance Ministers will have until 7 November 2011 to iron out the details and get this plan in place.

It is also important to note that these changes to the EFSF will not require further ratification by each individual national parliament.

**Strengthening the banking system**

The EU banking system will be strengthened by the ongoing provision of liquidity and an increased capital requirement.

The provision of liquidity to the banking system will be done via “facilitating access to term-funding through a coordinated approach at EU level.”

This is a very important step to ensure that the inter-bank funding market in Europe remains open and that the liquidity requirements of the banking system are met in a smooth and ongoing basis. This is crucial for the economic outlook in the EU.

In terms of the increased capital requirement, banks will now be required to increase their Tier 1 capital ratio to 9% by 30 June 2012. This increase in capital is estimated at €106.5bn, with a large share of this amount required for Greek (€30bn), Portuguese (€7.8bn), Spanish (€26.2bn) and Italian (€14.7bn) banks. Significantly, Irish banks are estimated to have no additional capital raising requirements, while both German (€5.2bn) and French (€8.8bn) have relatively low requirements.

The individual banks have until 25 December 2011 to submit plans to raise the required capital from the private sector.

Banks may well choose to improve their capital ratios through retained earnings and converting debt into equity before attempting to raise fresh capital from the markets.

If banks are unable to raise sufficient capital from the private sector, they can then approach their national governments and then the EFSF as a last resort. Banks that are below the 9% target by June next year will face "constraints" on paying dividends and bonuses.

It is also important to note that the EU authorities have stated that raising the capital ratio is not to be achieved via "excessive deleveraging" and that the banks must "maintain the credit flow to the real economy."

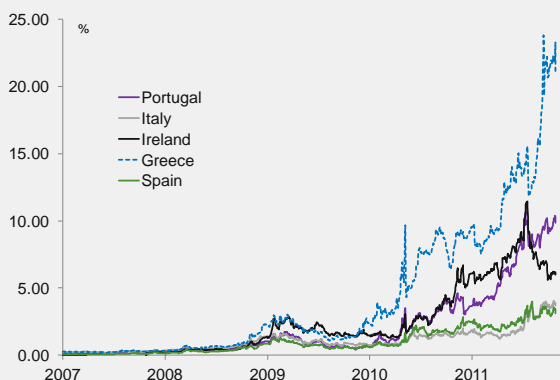
**Fiscal coordination and consolidation**

In terms of fiscal policy, the EU made special mention of the efforts recently undertaken by Spain and Italy to bring their budgets back under control. Markets will no doubt be watching these countries very closely to ensure they stick to their commitments. Italy in particular has committed to achieve a balanced budget by 2013 and a structural budget surplus by 2014. This should reduce gross government debt to 113% of GDP in 2014.

The two other countries currently receiving financing from the EU authorities, Portugal and Ireland, also got a special mention. The EU noted that they are "pleased with the progress made by Ireland in the full implementation of its adjustment program which is delivering results." On Portugal, the EU noted that it "is also making good progress with its program."

It is interesting to note in the chart below how the market is rewarding Ireland for the positive way it has gone about implementing its program, while Greece, on the other hand, has been dealt with strongly by the markets.

**10 year bond spread over Germany**



Source: Bloomberg. Data to 27 October 2011

Significantly, however, initial steps towards some type of fiscal union are also evident in the latest agreement. The EU President noted that options would be explored to "strengthen the economic union to make it commensurate with the monetary union" and that this may involve "limited Treaty changes."

In this regard national budgets "should be set based on independent growth forecasts" and that Member states in excessive deficit will have the draft of their national budgets examined by the European Commission who will provide an "opinion on them before their adoption by the relevant national parliaments."

In addition, each Member state will have to adopt rules on "balanced budget in structural terms" into their "national legislation, preferably at constitutional level or equivalent, by the end of 2012."

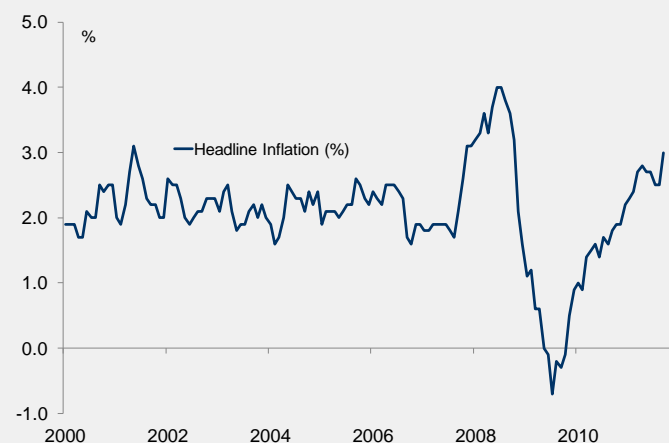
The EU leaders have also committed to greater coordination of tax policy with work on a "common consolidated corporate tax base and for a financial transaction tax ongoing."

**Role of the ECB**

The European Central Banks (ECB) primary role will remain the control of inflation via monetary policy. In this regard we would expect the ECB to ease monetary policy by 25bp, taking the cash rate to 1.25%, when the new President, Mario Draghi, chairs his first meeting on 3 November 2011. Further easing back to a 1% cash rate could be expected in the months ahead.

This easing is likely to come despite the fact that EU inflation is currently running well above target (of under 2%) at 3.0% (see chart), although declines are expected in the months ahead as the economy has already slowed sharply.

**EU inflation**



Source: Bloomberg. Data to 30 September 2011

Significantly, in the EU statement there was no statement either one way or the other on whether the ECB will continue directly entering the sovereign bond markets to support vulnerable countries, such as Spain and Italy through their Securities Markets Program (SMP).

The German authorities have made it clear that they would prefer the sovereign bond purchase program to be undertaken by the EFSF (and eventually the ESM), but the ECB is not bound by this and the new President of the ECB is likely to see bond purchases as an important part of the ECB's ongoing role to maintain the integrity of the financial system,.

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