Colonial First State
Global Asset Management

Europe's sovereign debt crisis: a Herculean task ahead, with opportunities for infrastructure

Infrastructure research note

1 June 2010

- The recent sovereign debt crisis is an abrupt reminder that European economic integration remains a distant goal. While belated policy action appears to have bought some time, the task facing Europe's less competitive economies remains daunting.
- Governments' ability to overcome entrenched opposition to necessary but unpopular reforms will be crucial in order to minimise default risk in the medium term. Policies to encourage sustainable economic growth and development will also be high on the agenda.
- Infrastructure investors in Europe must contend with risks in the short term including capital market volatility, a disruptive operational environment, and weak macroeconomic conditions.
- Equally, the remedial actions countries governments must pursue will present unique opportunities for infrastructure investors. These include privatisations and greater emphasis on productivity-enhancing forms of spending such as infrastructure.
- In the long run, investors in those countries able to successfully transform themselves through reform will benefit from improved operating conditions for infrastructure assets.
- The challenge for infrastructure investors will be to anticipate and navigate these trends across Europe to their advantage – this will require deep understanding of macroeconomic dynamics and ongoing monitoring of structural reform efforts.

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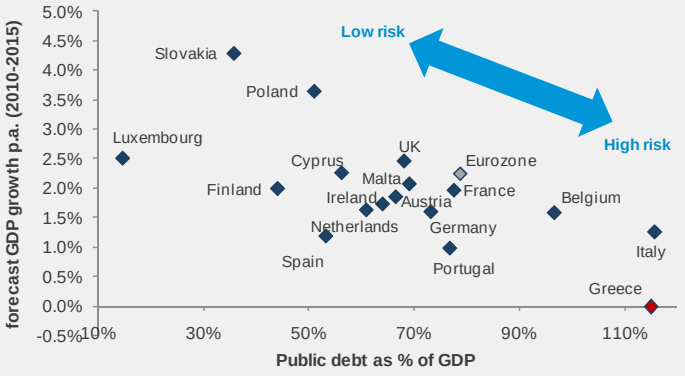
The story so far

Concerns over Greece's public debt burden date back to its entry into the Eurozone in 2001. At the time, it was granted admission despite not strictly meeting the Maastricht criteria surrounding government deficits and overall debt levels. In the ensuing decade, Greece enjoyed robust economic growth, fuelled by low prevailing interest rates in the Eurozone. Over this period, its fiscal position continued to deteriorate, while promised reform efforts fell well short of expectations. Markets were largely content to ignore these issues until late 2009, when incoming Greek Prime Minister George Papandreou revealed that the 2009 deficit would be 12.5% of GDP - significantly higher than the 3.7% stated earlier, and that the previous government had deliberately misreported the country's official fiscal statistics. Since then, the official EU statistical agency Eurostat has stated its lack of confidence in the figure, revising it to 13.6% and suggesting it could actually be above 14%.

These revelations prompted ratings agencies to progressively downgrade Greece's sovereign debt ratings, culminating in Standard and Poor's relegating Greece's bonds to 'junk' status on April 27. This was the first time since the introduction of the Euro that a Eurozone member had lost its investment grade status, and led to a rise in sovereign debt costs of other Eurozone countries including Portugal, Italy, Ireland and Spain. As Figure 1 reveals, these economies are among the riskiest in Europe, when indebtedness and economic growth prospects are considered.[1]

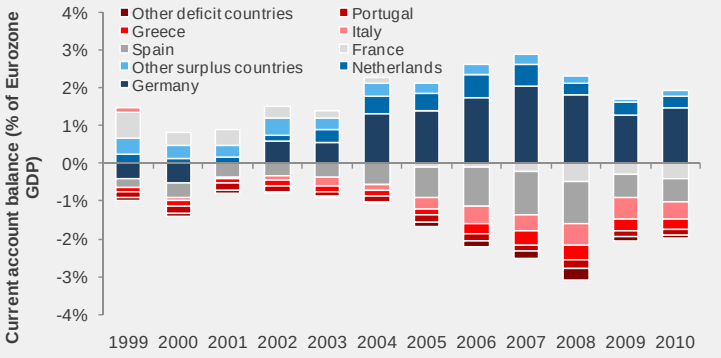
As the crisis morphed from a Greek sovereign debt issue into a broader financial crisis for the EU as a whole, the policy response from governments and monetary authorities changed in scale and scope. On April 11, Eurozone finance ministers approved a €30 billion standby aid facility, after weeks of political wrangling. On May 2, after it became clear that the risk of contagion had not passed, a three-year €110 billion package for Greece was negotiated by the IMF, the EC and the European Central Bank (ECB). This was followed up by a massive €750 billion package by the same bodies on May 10 for the entire Eurozone. The latest package, which included an agreement by the ECB to purchase government bonds from EU members on the secondary market, removes the need for Greece and other countries to access bond markets for financing for at least 3 years. This is designed to avert a liquidity crisis similar to the one witnessed in the aftermath of the Lehman Brothers collapse in 2008 over this period.

Figure 1: Public debt versus economic growth



Source: Eurostat, IMF and CFS Research

Figure 2: Eurozone current account balances



Source: IMF and CFS Research

Where to from here?

Given that the situation has changed almost on a daily basis over the past few months, it is difficult to predict what the next few months have in store. We believe the latest rescue package removes a lot of the uncertainty around policy, and should avert the risk of a liquidity crisis. However market participants are likely to remain jittery and highly risk-averse over the next few months.

The expiry of the EU rescue plan in three years' time shapes as a day of reckoning for European economies. As German chancellor Angela Merkel has stated, "we've done no more than buy time for ourselves to clear up the differences in competitiveness and in budget deficits of individual Eurozone countries." For Merkel's counterparts in Europe's less competitive economies, their task of turning their economies around in such a short time frame must evoke Hercules' mission to clean the Augean stables in a day.

The problem for the Eurozone is that its stated goal of economic convergence has not been achieved – instead the opposite has occurred, ironically due in part to the Eurozone's common interest rate and exchange rate.[2] As Figure 2 highlights, the seemingly uniform growth in the Eurozone's has been built on growing imbalances. Germany and the Netherlands run large current account surpluses, while the largest current account deficits are run by the countries currently under the microscope – Spain, Italy, Greece

[1] However, other factors are at play. For example, Belgium has a high level of debt but has not seen its risk premium rise to the extent of the other Southern European economies. This is arguably because its economy is perceived to be more competitive, and in less need of urgent reform. Another factor is the reliance on foreign lending for sovereigns. For example, Italy has a much higher level of debt than Spain, but has a higher proportion of domestic bondholders. As a result it is seen as less of a capital flight risk.

[2] For economies with higher than average growth and inflation (such as Spain and Ireland over much of the past decade), the prevailing Eurozone interest rate and exchange rate were too low relative to domestic economic dynamics. This contributed to asset price bubbles in these economies, and encouraged the fiscal excesses which led to today's sovereign debt crisis. What didn't occur nearly enough were the sort of tough reforms that must now be undertaken to improve economic competitiveness in the troubled economies.

and Portugal, as well as France in recent years. These trends will need to be reversed somewhat to ensure stability of the monetary union.

For countries across Europe more broadly, investors will be most focused on solvency risk for European economies. The ability for countries to improve their fiscal position and avoid an eventual default will depend on two interrelated factors:

- **Economic growth prospects**: if economic growth is anaemic, growth in tax revenues for a given country may not keep pace with the interest bill it faces on public debt. In countries such as Greece, where the economy is expected to contract over the next six years, the situation is even more extreme. The options for boosting economic growth are limited, particularly for Eurozone economies which have no direct control over interest rates (to boost consumer spending and investment) or exchange rates (to boost exports). The need for fiscal discipline will also constrain governments in their ability to implement expansionary fiscal policy, which in turn will act as a drag on economic growth.

- **Progress on fiscal and structural reform**: many of the proposed austerity measures, while necessary, are deeply unpopular. Social unrest has escalated in Greece throughout the crisis, with crippling strikes, and violent protests resulting in three deaths in Athens. Spain and Portugal have also announced austerity measures, and other countries are likely to follow. Whether governments will be able to implement austerity measures in the face of such fierce opposition and looming elections remains to be seen, particularly as these reforms will need to continue for some years to come.

These are ongoing issues, and the road ahead is likely to be a treacherous one for all involved. In the next section, we outline what we see as the key risks and opportunities from an infrastructure investment perspective.

Implications for infrastructure

Short term

In the near term (the next six to twelve months), we have identified the following key themes for infrastructure:

- **Market volatility and transaction activity**: wider corporate bond spreads, and heightened equity and currency market volatility are likely to remain; although as Figure 3 suggests, the level of uncertainty and risk aversion appears to have peaked for now. This is likely to have a moderate impact on infrastructure transaction activity as well as capital management (including currency hedging strategies/policies for investors based outside Europe) of infrastructure businesses. We believe financing will continue to be readily available for brownfield assets, although the amount of gearing available will be dependent on the type of asset, applicable regulatory oversight, regional economic dynamics and other asset-specific factors. Due to the pull-back in bank lending, utilities' corporate bond issuance in Europe has reached record levels, and we expect that the capital markets will continue to be an important alternative to traditional bank financing over this period.

- **Operational disruption**: As we have seen, the crisis has taken on a social dimension which has affected the physical operation of some infrastructure assets. In Greece, airports, port and rail operations have been disrupted in recent months by general strikes protesting pension reforms which are part of the austerity measures. Other countries including France, Portugal, Spain and Romania have also been affected by protests and strikes so far this year, with further strikes almost inevitable over the next few months as unions react to reform measures.

- **Economic slowdown**: even prior to the current sovereign crisis, European GDP growth was lagging behind other regions such as Asia and North America. As consumer confidence deteriorates and fiscal policy tightens, Europe's growth is likely to slow down further in the short term. Assets such as airports and ports are most vulnerable in this environment as their patronage levels are typically correlated with GDP growth.

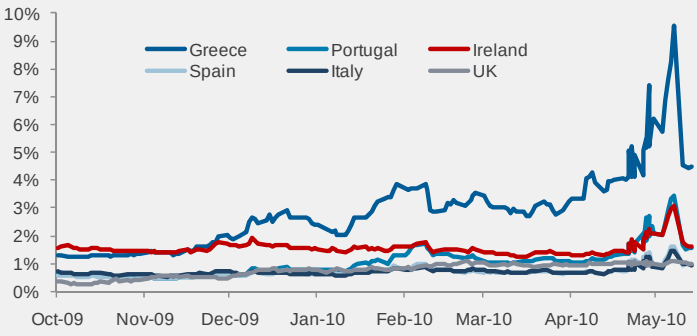
- **Uncertainty over government support:** Infrastructure assets that have a heavy reliance on government funding may be at some risk. For example, the level of subsidies available to operators of renewable energy generating assets is likely to come under pressure. This is particularly true in countries such as Spain, where existing subsidies have been perceived as overly generous relative to technology and efficiency-driven reductions in the cost of renewable energy generation. A key issue for infrastructure investors will be whether any changes only apply to new projects, or whether they will be implemented retroactively. Given that governments will need to maintain credibility with investors to attract and retain private capital for infrastructure development and capital expenditure requirements, we see the failure to honour existing agreements as a less likely outcome – however the uncertainty surrounding this is likely to weigh on investors in the interim.

  Governments are also likely to review its funding of new infrastructure projects, including those delivered under PPP arrangements. The Portugese government has already announced that it will delay the construction of the new €5 billion Lisbon airport and adjacent €1.2 billion Tagus road and rail bridge indefinitely, while the Italian government has postponed the proposed €6.1 billion Messina bridge linking Sicily to the mainland. Projects structured under availability-payment models are also likely to be scarce in the short-term. These projects are typically (i) less economically viable than other projects (and hence unwanted by the private sector), and (ii) able to be delayed due to the easing of capacity constraints brought on by the expected slowdown in demand resulting from a more sluggish economic environment. Countries with

infrastructure spending requirements that are orientated to Greenfield projects will likely experience a greater impact than more developed countries, where maintenance capital expenditure dominates, and is usually part of an established regulatory framework.

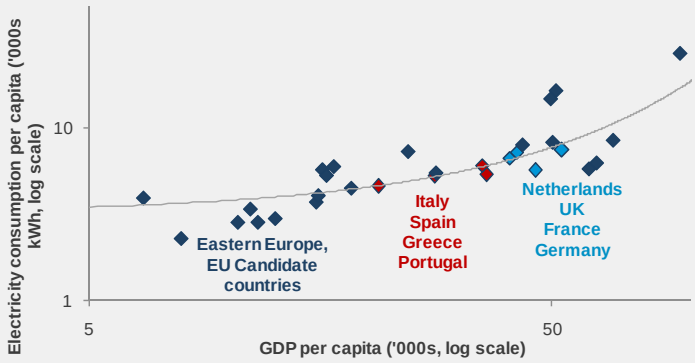
Beyond the next twelve months, we are likely to see some attractive investment opportunities arise. Greece's announced austerity package has included government privatisations, with the state currently holding ownership stakes in telecommunications, water, electricity and gas assets. These opportunities are also expected to arise in other countries, as well as at the state/provincial and municipal levels of government. Given the politically sensitive nature of these privatisations and concerns about maintaining employment levels, we anticipate that the partial privatisation model already adopted in countries such as Germany and the Netherlands will prove a more expedient option over the next two to three years.

Figure 3: 10 yr sovereign bond yield spread above Germany



Source: Bloomberg and CFS Research

Figure 4: Electricity consumption versus GDP per capita



Source: IMF, CIA World Factbook and CFS Research

Medium to longer term

In the medium term, structural reform presents a number of opportunities for infrastructure investment. Firstly, privatisations should continue to occur. Given that these are likely to occur at a time when economic growth is below-trend (a scenario we expect, due to tight fiscal policy acting as a drag on GDP), then this may provide an attractive entry point for investors in terms of pricing; notwithstanding the desire of governments to maximise privatisation proceeds. Secondly, investment in productivity-enhancing infrastructure is likely to have a greater and more lasting impact on economic growth than, for example, government transfer payments or other forms of discretionary spending. Thus, encouraging private sector investment in infrastructure – both new-build and maintenance – will be a high priority for governments.

Investors need to think beyond the economic cycle and consider what impact these changes will have on the long-run development of countries. The ten year cumulative impact of Greece's lower growth outlook, for example, is significant. According to our calculations, Greek GDP per capita in 2020 could be nearly 30% lower than would have been the case if historical growth rates had been maintained. Similar outcomes could be faced by Spain, Italy and Portugal, which – as Figure 4 highlights – are all positioned between the wealthier economies of Germany, France, the UK and the Netherlands, and the less developed European economies (including Eastern Europe and EU candidate countries) in terms of GDP per capita. Whether these countries manage to successfully bridge the gap with the leading economies, or regress to the rest of the pack remains to be seen. Our view is that the possibility of a more economically divergent Europe in the medium term cannot be discounted.

At the asset level, the resultant level of economic wealth will govern the new equilibrium level of demand for infrastructure services. As Figure 4 highlights, even for more stable infrastructure sectors such as the electricity sector, consumption *levels* are a function of economic wealth (as measured by GDP per capita).[3] The income elasticity of demand for other infrastructure-related services, such as air travel will typically be higher, meaning an even greater potential impact on demand levels. We note, however, that such impacts will not be unequivocally negative. For example, consumers may substitute their international holidays (implying use of airports) with cheaper domestic holidays (implying a greater use of motorways). Likewise, a decline in domestic industry due to a competitiveness gap with neighbouring economies may imply a greater share of imported consumer goods, which could provide a throughput boost to freight rail and port facilities. The challenge for infrastructure investors will be to anticipate and navigate these trends across Europe to their advantage.

For those countries able to successfully implement reform, then there will be benefits for long-term infrastructure investors once the necessary painful adjustment phase passes. Better policy transparency, corporate ethics, business operating environments, lower corruption, more flexible labour markets, and regulations more conducive to foreign investment are all likely outcomes. This would effectively reduce the level of risk associated with investing in these markets. In addition, structurally lower unemployment (a key goal in many European economies' reform efforts) will improve the utilisation of existing infrastructure assets, as will the proposed increases in retirement age, which should provide an economy-wide boost to productivity, and hence demand for infrastructure services.

[3] Note the subtle distinction between this point and discussion around the relative stability of consumption (as demonstrated by the correlation between the change in consumption and the change in GDP or other variables such as industrial production).

Summary

While short term market volatility is likely to remain, policy actions have reduced the likelihood of a liquidity crunch in the short term. Nevertheless, a medium term solvency issue remains, and can only be averted through painful, difficult structural reform to improve competitiveness in certain economies. Investor focus has now shifted to the types of reforms that need to take place, the likelihood of these being achieved in each country or industry, and the positive/negative consequences of success/failure.

For infrastructure investors, key risks in the short term include a disruptive operational environment, capital market volatility, and weak macroeconomic conditions. However, the actions governments must pursue in order to transform their economies will also create opportunities for infrastructure investment. Asset privatisations have already been announced as part of austerity measures and reform efforts; and the emphasis on generating sustainable growth and development will see productivity-enhancing forms of spending such as infrastructure expenditure gain prominence.

The economic development paths of economies are also likely to be significantly impacted by the crisis. We may yet see a more economically divergent Europe in the medium term, which will have profound implications for consumption and demand patterns across and within countries. However, in the long-run, those economies which are able to successfully implement reform will offer more attractive conditions for infrastructure investors. The challenge for investors will be to anticipate and navigate these changes to their advantage – something that will require a deep understanding of macroeconomic dynamics and ongoing monitoring of structural reform efforts.

The Greek sovereign crisis, like the subprime crisis before it, highlighted the dangers in adopting a 'shorthand' version of risk assessment that fails to adequately identify and price risk. In a forthcoming research piece, we will provide some insight into our proprietary processes designed to systematically and rigorously assess European countries from an infrastructure investment attractiveness perspective. The resulting rankings are just one of many inputs into our investment decision making, but one that has the potential to highlight 'red flags' by incorporating some of the issues facing countries that are highlighted in this report.

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