

European update: Progress and problems

Economic research note

16 November 2011

- Implementation risk around the 26–27 October EU agreement has dominated markets in recent weeks.
- Political change in both Greece and Italy, and pending change in Spain, is a positive, but much work remains to be done across these nations to stabilise the sovereign debt markets.
- With the EU economy continuing to weaken, the required fiscal austerity is likely to add to the risk of recession, further weighing on global markets.
- For Italy and possibly Spain, market developments are heading towards the need to access funds from the EU authorities and/or the IMF. However, given their size, this is likely to be in the form of some-type of hybrid model, with some funding from the markets and some funding from the EU/IMF.
- The ‘big bang’ policy development could be large scale bond purchases by the ECB, to drive bond yields back down to sustainable levels. This would likely be seen as a positive by markets.
- Both the ECB leadership and Germany, however, remain strongly opposed to such a move. But this option could become more palatable to the ECB if the EU sovereign debt crisis continues to spiral downwards, weakening the EU economy further.

Europe: Progress and problems

After the 26-27 October 2011 agreement by the European (EU) leaders to implement a comprehensive package of measures to help stabilise the sovereign debt situation, we described these developments as a “step in the right direction” (see note *Europe takes a step in the right direction*, 28 October 2011).

However, in that note we also stated that “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.”

And so this risk has proven to be.

Political developments have dominated in both Greece and Italy since late October and the markets have taken a very dim view of the inability of the previous political leadership to implement what was promised.

New leadership in both Greece and Italy has been seen as a positive development by markets – and so it is. However, much work remains to be done to stabilise the situation in the EU, while a continuation of the economic slowdown seems inevitable, with a building risk of recession.

In this note we highlight the situation in Greece, Italy and Spain and look at what is widely considered to be a more dramatic solution to the sovereign debt problems – **substantial and unsterilised bond market intervention by the European Central Bank (ECB).**

While such intervention is possible and would likely be seen by the markets as a very positive development, the opposition to such a move within the ECB and, especially in Germany, remains very high.

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Economic and market fundamentals

The following two charts summarise the economic and market situation in a number of EU countries. The first chart shows the 10 year bond spread over Germany, while the second looks at the diverging unemployment rates across the region.

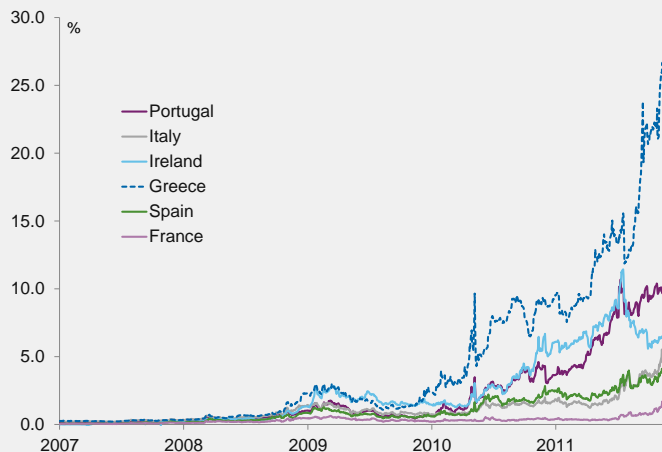
In terms of the 10 year bond spread chart, note how the markets have continued to punish Greece for its inability to implement the required policies.

On the other hand, the markets have largely rewarded Ireland for the no-nonsense way that country has gone about implementing the policy measures and fiscal austerity required.

In addition, the rapid increase in Italian bond spreads of recent weeks can clearly be seen, adding to the pressure on the political system and the need for quick and compelling structural reforms.

Bond spreads in Spain and France have also begun to rise in recent weeks, putting added pressure on the governments of both those countries to implement to required fiscal austerity.

10 year bond spread over Germany



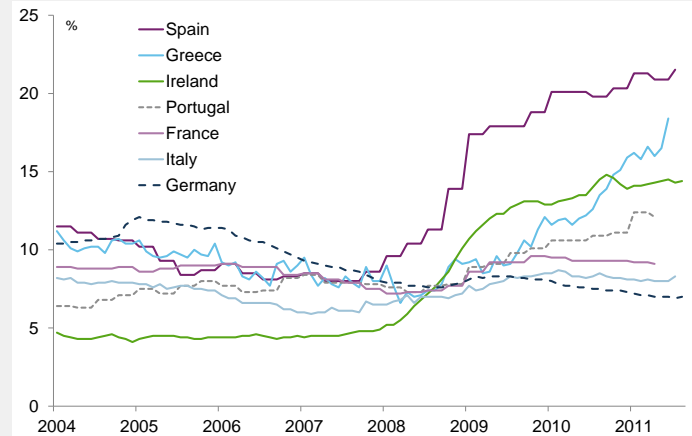
Source: Bloomberg. Data to 15 November 2011

The second chart shows the unemployment rate across a number of EU countries - demonstrating the weak economic environment in which many EU economies are operating.

It is important to note that up until 2008 the unemployment rates across Europe were converging. Since then there has been a dramatic deterioration, with rapid increases in Spain, Ireland and Greece, in conjunction with their weak economic performance.

On the other end of the scale, the unemployment rate has been relatively flat over recent months in France and Italy, while the German unemployment rate is still lower than was the case in 2008.

Unemployment rate in Europe



Source: Bloomberg, data to 30 September 2011

It is in this context that the outlook for inflation in the EU seems very benign, especially given the large output gap as evidenced by the weakness in the labour market. Despite the fact that the EU inflation rate is currently well above target at 3.0%, **this could help appease the ECB's inflation fears if they do decide to implement large scale unsterilised bond market intervention**. The exception to this is Germany, which unsurprisingly is providing the most push pack on QE by the ECB.

Greece

Former Governor of the Central Bank of Greece and vice President of the ECB, Lucas Papademos is now the Prime Minister (PM) of Greece. His government will include the retention of Evangelos Venizelos as Finance Minister.

The new unity government includes 36 members from the ruling Pasok Party, with 6 from the opposition New Democracy Party (including the position of Foreign Minister) and 4 from the smaller LAOS opposition party.

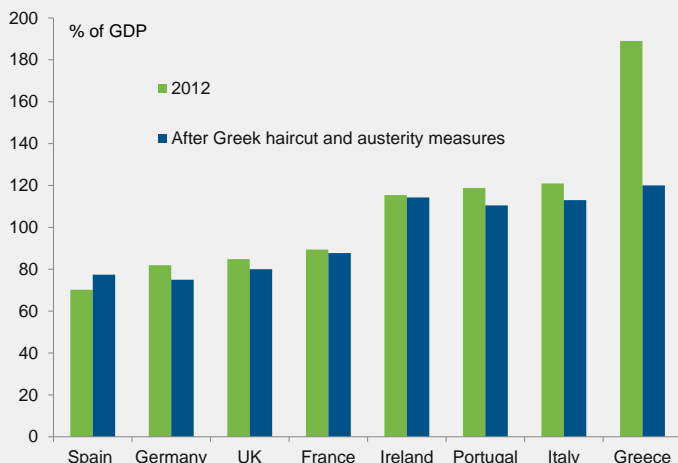
The new PM has made it clear that his immediate priority is to implement the policies required to fulfil the Greek agreement on the 26-27 October package to allow the next tranche of €8bn in funds from the "troika" (the EU, ECB and IMF) to be paid to Greece. It has been reported that the PM will meet with the troika as early as next week.

These funds are required by 19 December, at the very latest, as Greece has bond maturities to be paid by then.

The urgency of the situation is also underscored by the latest estimates of the European Commission, which stated that Greece's national debt, currently estimated at €345bn, would reach 163% of GDP in 2011 and 198% in 2012 – if the policies detailed in the 26-27 October agreement are not implemented.

As we stated in our note of 28 October, even with full implementation of the Greece support package, gross debt to GDP will still be a very high 120% by 2020, higher than the remainder of the EU nations.

Government gross debt/GDP



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

While the political changes in Greece should be seen as a positive, Greece has a long way to go before it gets on top of its debt mountain, while implementing the required fiscal austerity package will likely keep the economy in a weak state for a number of years to come.

The direction of the new Greek PM seems clear: he wants Greece to remain in the EU. At the start of debate for a confidence motion in his new government the Greek PM stated that "our membership of the euro is a guarantee of monetary stability and creates the right conditions for sustainable growth. Our membership of the euro is the only choice."

Italy

Italy's new Prime Minister (PM) is Mario Monti, a former EU Commissioner, after the resignation of long-serving former PM Silvio Berlusconi.

This news was initially greeted warmly by the markets, with 10 year yields rallying from a high of 7.48% (576bp over Germany) to a low of 6.45% (456bp), before selling off again overnight to 7.07% (529bp).

The first priority for the new PM will be to implement fiscal austerity measures recently agreed to and stabilise the Italian debt market.

The key issue for Italy is not so much one of the solvency of its debt, which is high at €1.6trillion, but liquidity.

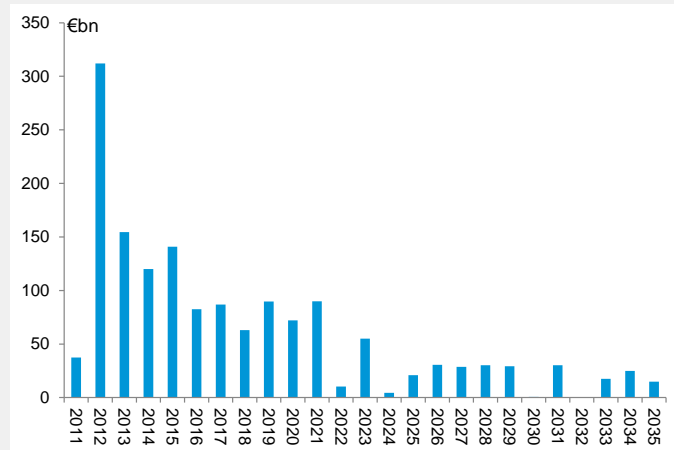
With a huge amount of debt maturing in the next few years the real issue remains Italy's ability to access markets for this ongoing funding need at interest rates that are consistent with financial sustainability, ie. less than 7% for a 10 year bond.

As an example, Italy issued a €3bn 5 year bond this week, which was sold at a yield of 6.29%, up from 5.32% on 13 October when the last equivalent tender was held and the highest yield since 1997.

Based on data from Bloomberg, the principal value of Italy's total government debt on issue is currently €1.6trillion.

For the remainder of 2011 this amounts to €31.3bn of debt that needs to be refinanced. More importantly, just over €310bn of this debt will mature in 2012 and require refinancing. This will then trail off to an estimated €155bn in 2013, around €120bn in 2013 and back up to €140bn in 2015. See chart below for maturity profile.

Italian government bond maturity profile



Source: Bloomberg

In addition, in 2010 Italy ran a budget deficit of just over €67bn or 4.6% of GDP, while the 2011 budget deficit year-to-date as at October was running at €60.8bn. For 2012 this budget deficit is expected to shrink to around €36bn and then expected to be balanced in 2013. However the ability of the new government to reach this target remains to be seen.

The new political leadership in Italy will, therefore, quickly need to rein in the current budget deficit and show real signs of stability and strength that convince markets that the deficit situation is coming under control.

The alternative is for market uncertainty to continue to build, taking bond yields to a level where financing costs will exceed those where financial stability is achievable, this could be estimated at 7%, where Greece, Portugal and Ireland requested assistance from the EU/IMF.

The other alternative for Italy is, of course, that like Greece, Ireland and Portugal, that they are forced to obtain their funding not from financial markets, but from the EU authorities and the IMF.

The key problem here is, of course, that the EU authorities, namely the European Financial Stability Facility (EFSF), does not have sufficient resources to fund all of Italy's needs.

Note that while the EFSF was expected to be leveraged up to €1 trillion as part of the 26-27 October agreement, this has not yet happened and the current lending power of the EFSF is only €440bn, the bulk of which will be needed to cover Greece, Ireland and Portugal.

One compromise could be that Italy receives part of its funding from the EFSF/IMF and part from the market, depending on how market conditions unfold and the new political regime in Italy proceeds.

This hybrid approach could work for Italy, but would likely come with very tough criteria and management from the EU authorities and the IMF, ie. any loss of market discipline on Italy would be replaced by EU/IMF imposed discipline. One expects, however, that the new Italian PM would be much more willing to accept this imposed discipline than the outgoing PM.

Financial markets are also penalising Italy for a weak economic growth outlook. The Italian economy has been significantly underperforming that of France and Germany since the formation of the EU. Since 1999, Italy's real GDP has increased around 9%, compared to France of 20% and Germany of 18%.

This has largely been driven by structural inefficiencies in the Italian economy, in particular excessive regulation that has led to high barriers to competition in the services sector and a high level of government ownership.

Employment participation and productivity has also been constrained due to the taxation system, while other issues include a centralised wage bargaining system and strong employment protection legislation.

All of these structural impediments have reduced GDP growth. Financial markets now want large scale structural reform in a short amount of time. Unless new PM Mario Monti can deliver credibility on this front, a new financing package for Italy may not be enough to convince markets about a more positive outlook for the Italian economy.

Spain

General elections will be held in Spain on 20 November, with opinion polls showing a likely change in government from the current Socialist Workers Party to the more conservative People's Party, led by Mariano Rajoy.

Spain is in a different debt position and as shown from the bond spread chart above, so far markets have not shown significant concern – although bond spreads have been rising in recent weeks.

At less than 80% of GDP, Spain's gross debt levels are not high by EU standards – see chart above. However, **this debt is being accumulated at a rapid rate, with the 2010 budget deficit coming in at 9.3% of GDP.**

The real issue for Spain is its lack of economic growth and the drag this is on fiscal performance. As shown in the chart above, at 22.6% the unemployment rate in Spain is the highest of all the major nations.

Spain also has a large level of household debt that is then reflected in the banking system – the legacy of a house boom that went bust (ie. much like in Ireland). This is around 90% of GDP (compared to around 50% in Italy) and 120% in Ireland.

Spain's current volume of government debt outstanding is €657bn. However, some €135bn of this debt will need to be refinanced in 2012. Combined with a potential budget deficit next year of around €35bn, this will amount to a substantial call on financial markets in the year ahead.

Much like Italy, **the new Spanish government will need to quickly implement the fiscal austerity measures**

needed to convince the market that debt levels will be bought under control and that the refinancing needs over the next year will be able to be achieved at reasonable interest rates.

Like Italy, the alternative to this scenario is either a full or partial involvement by the EU/EFSF/IMF to help meet the liquidity needs of the nation.

One of Spain's biggest economic issues is the rapid pace of deleveraging that is being undertaken. While this is necessary, it is likely to hamper growth over coming years. One benefit of Spain though is an improvement in the current account balance and a relative dynamic manufacturing industry.

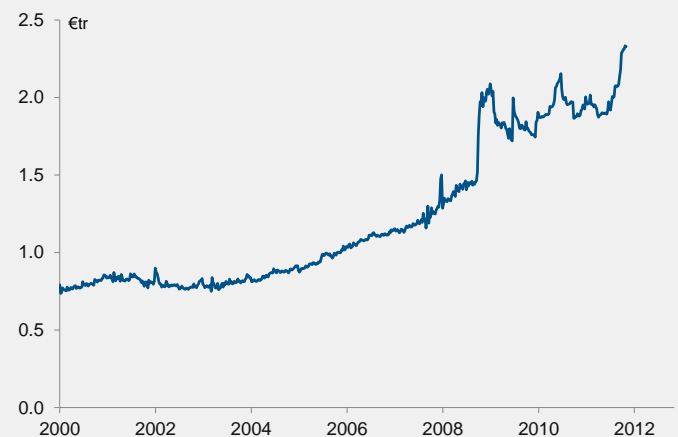
Role of the ECB

Up until now the ECB has tried to support the economy in three ways 1) easing monetary policy, via a 25bp rate cut, to 1.2%, on 3 November, 2) providing liquidity to the banking system via term funding and 3) through purchasing bonds in both the primary and secondary markets via the Securities Markets program (SMP).

The SMP involves sterilised intervention, ie. the cash used to buy the bonds is taken back out of the system, and so is very different from the quantitative easing (QE) programs of the US, UK and Japan.

This can be seen by the limited increase in the ECB's balance sheet in recent months, despite the fact that the ECB has purchased €115bn in government bonds since the SMP was restarted on August. The total amount of the program currently sits at €192bn

ECB balance sheet



Source: ECB, Bloomberg, Data to 4 November 2011

The big issue for the ECB is, however, are they willing to take a huge step forward in helping solve the EU sovereign debt crisis and begin a program of QE?

This would likely take the form of substantial purchases in sovereign bonds in the market (ie. into the hundreds of billions of euro), sufficient to drive down yields across the curve for many sovereigns, ie. especially Italy and Spain.

Up until this point the ECB, under both the previous and current President has stressed that this is not possible and would compromise the ECB inflation fighting mandate.

However as the chart on EU unemployment rates illustrates, there is a large output gap in many parts of Europe and this could help cool inflation fears. However the exception to this would be Germany, where the unemployment rate is at 20 year lows.

The German government is also strongly opposed to this measure, while the Germany representative on the ECB, Bundesbank President Jens Weidmann, has stressed that the ECB cannot become the 'lender of last resort' and that such a move is in fact illegal under the rules which forbid the ECB from lending money to individual governments.

The issue for the ECB remains, however, where does the EU sovereign debt crisis get to the point where there remains no other option, short of a dysfunctional break-up of the euro area, for the ECB to undertake a sizeable QE program?

The ECB is no doubt playing hard ball now to force significant reform and austerity measures in Italy and Spain, but it remains probable that significant and direct intervention into bond markets may be required by the ECB in the months ahead – despite the current strong objections from within this organisation and in Germany to such a policy path.

It is worthwhile looking at the size of QE programs by the US Fed and Bank of England (BoE) to consider the possible size of intervention, if the ECB were to proceed down this path.

Both the US Fed and BoE have undertaken bond purchases worth 17% of GDP in their respective QE programs. For the ECB if a similar size program was undertaken, this would amount to €1.6tr of sovereign bonds, or surprisingly the same amount of Italian sovereign bonds on issue.

While it would be unlikely that the ECB would undertake such an aggressive QE program, even a less aggressive initiative, of around 8% of GDP, could be worth €750bn. This would go a long way to begin to 'ring fence' Italy and Spain from the rest of Europe.

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