

Greece, Ireland, etc... the ongoing European debt debacle



Key points

- While Ireland has now been granted financial assistance from the International Monetary Fund (IMF) and European Union, concerns remain regarding Portugal and Spain.
- Spain is a bigger risk, as it comprises nearly 12% of the euro-zone economy and European banks have a higher exposure to it. While its small savings banks are a risk, fortunately its public finances are in better shape.
- The economic backdrop is more supportive than during the mid-year Greek crisis as the German economy is holding up well, supporting the rest of Europe.

Introduction

Public debt problems in peripheral countries in Europe have been a recurring issue all year. Earlier this year, the worry was Greece, in the past month it has been Ireland, and investors still worry about Portugal and Spain.

Back in May there was concern European sovereign debt problems would lead to another freezing up of credit markets, triggering a global 'double dip' back into recession. Our view was that because a) global monetary conditions were very easy, b) the global economy was stronger than at the time of Lehman's demise, and c) policy makers were moving fast with Europe's €720 billion support package, it would be more like the Asian crisis of 1997-98. In other words, European public debt problems would be an ongoing source of volatility in markets, but largely contained. So far this has been the case, with no signs of the credit or economic stress that came with the global financial crisis (GFC). But recent developments highlight that risks remain significant.

Why the recent flare up?

The recent flare up seemed to start with Ireland admitting it would need to raise €31 billion (or 19% of Irish gross domestic product [GDP]) to provide capital support for its banks. This was made worse by European proposals that bond investors may need to share in the cost of debt restructurings and more upward revisions to Greece's public debt. This saw public sector bond yields in Ireland pushed up to new crisis highs and made investors worry again about Portugal and Spain, with a renewed sharp rise in their bond yields as well. Fearing the consequences of renewed market panic, European authorities encouraged Ireland to apply for assistance. It has now been granted, with a €67 billion support package as Ireland undergoes another round of austerity measures.

However, speculation has remained that Portugal will need assistance. The good news is that Greece, Ireland and Portugal comprise only 6.3% of the euro-zone economy. Providing

assistance for Portugal as well wouldn't be a major stretch financially for Europe, and these economies aren't big enough to have a noticeable impact on Europe's economy. The trouble would be if Spain was also affected.

Why the concern over Spain?

Spain, and even Portugal, are very different to Greece. Prior to the GFC, Spain was running a budget surplus. Its budget deficit now seems to be coming back under control and its public debt to GDP ratio is below that of Germany and the US (see table below). In short, it doesn't suffer from the solvency issues that trouble Greece.

The public debt blow out

	Budget balance, % GDP (Deficit [-] or surplus [+])			Gross public debt, % GDP, 2009
	2009	2010	2011	2009
Austria	-3.5	-4.7	-4.6	67.5
Belgium	-6.0	-4.9	-4.2	96.2
Czech Republic	-5.8	-5.4	-5.7	35.3
Denmark	-2.7	-5.5	-4.8	41.4
France	-7.5	-7.8	-6.9	78.1
Germany	-3.0	-5.4	-4.5	73.4
Greece	-15.4	-8.1	-7.1	126.8
Hungary	-4.4	-4.5	-4.3	78.4
Ireland	-14.4	-11.7*	-10.8	65.5
Italy	-5.3	-5.2	-5.0	116.0
Netherlands	-5.3	-6.4	-5.4	60.8
Poland	-7.2	-6.9	-6.5	50.9
Portugal	-9.3	-7.4	-5.6	76.1
Spain	-11.1	-9.4	-7.0	53.2
Euro-zone	-6.3	-6.6	-5.7	79.2
Iceland	-9.1	-6.4	-2.7	122.7
UK	-11.4	-11.5	-10.3	68.2
US	-11.0	-10.7	-8.9	83.0
Japan	-7.2	-7.6	-8.3	192.9
Australia	-3.9	-3.2	-2.4	19.2
New Zealand	-3.5	-4.3	-3.7	35.0
OECD average	-7.9	-7.8	-6.7	90.3
Emerging average	-4.8	-3.7	-2.9	37.4

* 32% if the bank bailout is included. Source: Organisation for Economic Co-operation and Development (OECD), IMF, Eurostat, AMP Capital Investors.

The main concerns appear to be that its weak economy (with 20% unemployment) will lead to further real estate losses and more problems for its banking sector; notably its small savings banks, which account for a big chunk of Spanish banking sector assets. This would all lead to a worsening in its public sector finances, particularly if bank bailouts are required. There is also a degree to which concern over Spain (and indeed other countries in Europe) is becoming self-fulfilling in that investor panic is driving higher bond yields, making it harder for Spain (along with Portugal) to service

its public debt and forcing it closer to needing assistance. Higher public sector bond yields also push up private sector borrowing rates, making life tougher for private sector borrowers as well.

A bailout for Spain may be feasible in the context of the €720 billion facility announced in May, but only just. However, some European officials have said the facility could be increased in size. That said, it would come with much bigger political conflict in Europe and raise more serious questions about the future of the euro.

A full blown crisis in Spain would also have a much bigger economic impact, as it comprises 11.8% of the euro-zone economy and German and French banks have a much greater exposure to Spanish debt than they do to Greek, Irish and Portuguese debt. The Spanish exposure of German banks is equivalent to 1.8% of their assets and for French banks it is 1.5% of assets. Fortunately, US banks have little exposure to debt in troubled European countries.

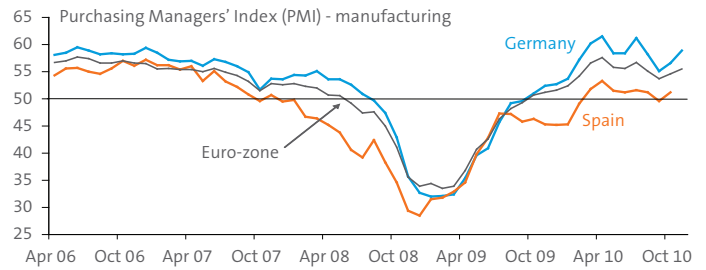
Some grounds for optimism

It is critical the contagion flowing through Europe ends soon, before tipping Spain over the edge. On this front, there are some grounds for optimism. First, European authorities have got the message and have been moving quickly to provide assistance to Ireland, and would probably do so quickly in the case of Portugal as well if required. Second, real estate loan losses in the case of Spain are likely to be far smaller as a proportion of GDP (maybe adding 10% to the public debt to GDP ratio) than in Ireland, suggesting far less risk to the Spanish banking system. This is likely to be confirmed by another round of bank stress tests for Spanish banks, which Spanish authorities have committed to provide. Thirdly, although worth keeping an eye on, so far there is little evidence of panic in money or credit markets, with spreads remaining well contained compared to the situation in 2008. This includes bank borrowing spreads in Europe. Finally, if the crisis doesn't settle down soon we are likely to see renewed buying of government bonds in troubled countries from the European Central Bank; an action that helped stabilise the Greek crisis mid year.

More broadly, it's interesting to note that unlike at the height of the Greek crisis in May-June, this time around there has been less weakness in share markets. This in part likely reflects better economic news in Europe. In May, the European purchasing managers' index (a survey of business conditions) was starting to fall, fuelling worries of a double dip. However, in recent months it has surprised on the upside. In particular, this reflects strength in Germany and other northern European countries offsetting softness in countries with debt problems (see next chart).

Germany seems to have been a key beneficiary of the crisis via a weaker euro. The overall business climate in Germany, as measured by the IFO survey, is at an all-time high, and Germany's unemployment rate is at its lowest since 1992. Germany comprises 27% of the euro-zone economy.

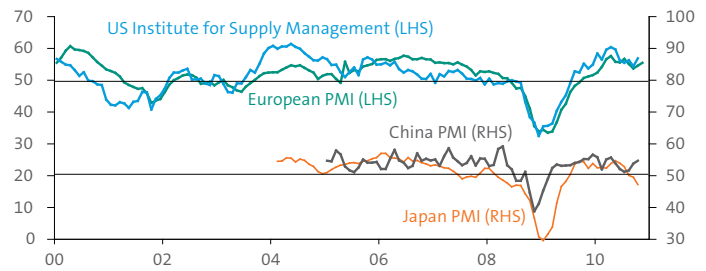
European business conditions are holding up well



Source: Bloomberg, AMP Capital Investors

More broadly, and with the exception of Japan, business conditions indicators globally appear to have mostly stabilised or improved after generally falling in mid year.

Global business conditions



Source: Bloomberg, AMP Capital Investors

Concluding comments

There are several points worth concluding on. First, while European public debt woes will likely remain a periodic source of fragility in the global economy and volatility in financial markets, policy action should be enough to prevent them becoming a full blown crisis. Spain is worth keeping an eye on in the short term, though. Secondly, just as the outlook for the US dollar is bleak, the problems with debt in Europe suggest the same in relation to the euro. The experience of Iceland, which now seems well on the way to recovery thanks in part to a plunge in its currency, highlights the benefit of allowing a weaker currency in response to debt problems. Thirdly, the public debt problems in Europe are of course part of a wider debt problem in major advanced countries, including the US and Japan, which will act as a constraint on their growth for many years to come. This is in contrast to emerging countries where public debt is not really an issue. Finally, while Australia has little public debt and has little trade exposure to Portugal, Ireland, Greece and Spain, it is affected via financial market and economic sentiment. Fortunately, it is more exposed to strongly growing emerging countries. The main risk for Australia would be if the European public debt woes led to a renewed credit crunch, which would again make it more costly for Australian banks and businesses to raise funds offshore. So far, though, this appears unlikely.

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