

The Euro-zone public debt crisis (again)

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Key points

- The spreading of the European debt crisis into Italy and Spain is worrying given their greater size. It is clear the crisis is a long way from being resolved, and seems to be following a course like the Asian crisis of 1997-1998 or the US subprime crisis of 2007-09.
- Fortunately the emerging world is strong and the US is likely to introduce further quantitative easing if the outlook darkens too much, but European debt issues will likely remain a threat and a source of volatility for a while to come.

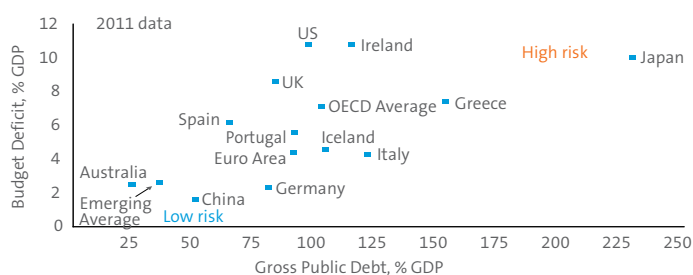
Introduction

It seems the European sovereign debt problems won't go away. Despite bailouts for Greece, Ireland and Portugal, and numerous policy moves, it keeps rolling on with concerns Spain and Italy are now being seriously drawn in.

Public debt compared

The chart below puts the public debt problem in Europe in context. The horizontal axis shows gross public debt relative to gross domestic product (GDP) and the vertical axis shows the budget deficit relative to GDP. Generally it's seen as desirable that the public debt to GDP ratio be below 60% of GDP and in order to keep debt stable the budget deficit should be around 3% of GDP or less. Many countries are above these levels.

The global public debt problem



Source: OECD, IMF, Eurostat, AMP Capital Investors

Emerging countries generally, and Australia, are in the low risk part of the chart. While there has been much concern about high levels of local government debt in China, even if an adjustment is made for recent estimates, it puts China's public debt at around 50% which is still moderate. High growth countries like China can also support higher levels of debt.

The problems with Greece, Ireland and Portugal are well known. Greece ran into trouble last year as the true extent of its public borrowing became known. Investors panicked, forcing borrowing costs higher. As a result it was given a bailout package from the European Union and the International Monetary Fund (IMF). Ireland went down the same path as its public debt spiralled in response to the Government having to prop up its banking

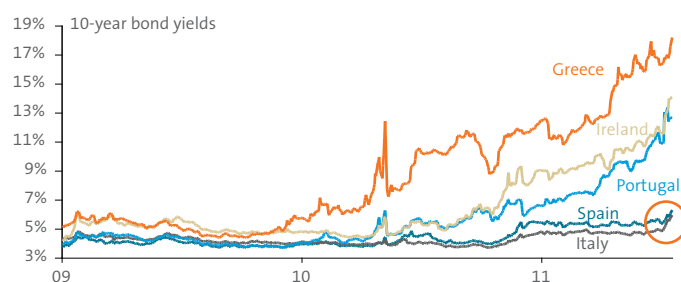
system. Portugal seemed more a victim of market panic made worse by political uncertainty. Iceland ran into trouble in 2008-09 but appears to be on the way to recovery as fiscal austerity has combined with monetary easing. Such an approach is not possible for Greece, Ireland and Portugal. So they have been left with spending cutbacks and tax hikes which have made the situation worse. Hence a continued rise in their yields, Greece's need for another bailout package and expectations of default - Greek 10-year bond yields now imply a 50% loss of their face value.

But why has Japan been able to get away with it? It has a far worse debt and budget deficit combination and yet its 10-year bond yield is just 1.1%. Basically more than 95% of its debt is held by the Japanese public, and the country is a net lender to the rest of the world (i.e. it runs a current account surplus, unlike Greece). Inflation is non-existent so the Bank of Japan could simply monetise much of its debt.

What about the US? The US has been let off relatively easily because there has been a high degree of trust it won't default, it borrows in US dollars, and there is much natural demand for US bonds from central banks in emerging countries that have been buying US dollars to stop their own currencies rising. The US 10-year bond yield is just 2.9%. However, time may be starting to run out with the US debt ceiling debate drawing attention to the issue. The debt ceiling will probably be raised by early August, but investors and ratings agencies are now hoping for decent budget cuts. There is also less concern about the UK because it has moved to put its deficit on to a more sustainable path.

Which brings us to Spain and Italy. Through much of this year bond yields in Spain and Italy were range bound.

Italian and Spanish bond yields have broken higher



Source: Bloomberg, AMP Capital Investors

However, they have now broken higher on fears that if Greece is allowed even a 'selective default', it will happen to other countries too. There are also signs that both countries are now flirting with recession as well as ongoing worries the Spanish Government will be forced to bail out its regional banks. In addition, Prime Minister Berlusconi is in a spat with his finance minister. **This suggests the 'firewall' built around Greece, Ireland and Portugal that had protected Spain and Italy may have broken and potentially takes the crisis to a new level.**

Why it matters if Spain and Italy are affected

There are several reasons why the flow-on to Spain and Italy is concerning. Firstly, they are much bigger economies. Together they account for 29% of Euro-zone economic activity against just 6% for Greece, Ireland and Portugal.

European debt and GDP compared

2010 data	GDP, billion euros	% of Euro-zone total	Gross public debt billion euros	% of GDP	% of Euro-zone total
Austria	284	3	205	72	3
Belgium	352	4	341	97	4
Cyprus	18	0	11	61	0
Estonia	15	0	1	7	0
Finland	180	2	87	48	1
France	1948	21	1591	82	20
Germany	2499	27	2080	83	26
Greece	230	2	329	143	4
Ireland	154	2	148	96	2
Italy	1549	17	1843	119	23
Luxembourg	42	0	8	19	0
Malta	6	0	4	68	0
Netherlands	591	6	371	63	5
Portugal	173	2	161	93	2
Slovakia	66	1	27	41	0
Slovenia	36	0	14	38	0
Spain	1063	12	639	60	8
Total	9204	100	7859	85	100

Source: Eurostat, AMP Capital Investors

Secondly, Spain and Italy account for nearly a third of Euro-zone public debt, compared to just 8% for the three peripherals. Italy in particular, with €1.8 trillion in public debt and over €550 billion in debt maturing in the next three years is likely too big to bail out. Finally, while German and French banks have between them a \$91 billion exposure to Greece, they have a \$323 billion exposure to Spain and a \$555 billion exposure to Italy.

Large bank exposures to Italy and Spain

Dec 2010 \$ billion	German banks	French banks	UK banks	Italian banks	European banks
Greece	34	57	14	4	136
Ireland	118	30	135	14	378
Portugal	37	27	24	4	195
Spain	182	141	107	30	632
Italy	162	393	66	0	784

Table shows total bank exposures to countries public and private debt.

Source: BIS, AMP Capital Investors

This all means the spreading of the debt crisis into Spain and Italy is worrying. And if Spain and Italy succumb, investors might also worry about Belgium and France.

Comparison to Asian and US subprime crises

The Euro-zone debt crisis is now feeling a bit like the Asian/Russian/emerging market crisis that ran from mid-1997 to October 1998. Or the US subprime crisis that ran from February 2007 to March 2009, with panic running from country to country and/or market to market with numerous insufficient policy moves along the way until some form of wash out or massive policy response does the trick. In the US subprime crisis it was the forced government recapitalisation of US banks and quantitative easing. This suggests the European debt crisis is a long way from over.

What are the policy options?

Ideally Greece, Ireland and Portugal, and to a lesser degree Spain and Italy, should be running fiscal austerity and easy money via lower interest rates and a currency depreciation. However, this approach is denied by the one size fits all European monetary union. Leaving the euro is not really an option either because of the financial panic it would create. There are effectively two options. First, resolve the short-term issues around Greece and increase the size and flexibility of the European Financial Stability Facility (EFSF) and hope this will keep investors away from Spain and Italy to give them more time to get back in order. This may involve allowing a partial default in Greece, but by increasing the firepower of the EFSF to say around €1.5 trillion from €750 billion now (if the IMF is included) and allowing it to buy bonds in the secondary market, it should hopefully provide confidence that default won't be allowed to happen in other countries. **This would see the EFSF become a step towards a common bond type instrument on the way to the ultimate solution, which is a fiscal union in Europe.** However, there are several constraints on this – it may take time to be approved by Euro-zone parliaments and the necessary borrowing to fund it by stronger countries like France and even Germany may threaten their credit ratings. The second option is to rely more on the European Central Bank (ECB) to buy up more debt and effectively monetise it (much like quantitative easing in the US). It's doubtful the ECB is yet prepared to do this, but it may be forced to. However, given the constraints the most likely outcome is more muddling along with periodic crises forcing more radical action, ultimately involving a mix of the above.

Investment implications - what to watch?

This all suggests the Euro-zone debt crisis will remain a source of volatility and threat for investment markets for some time.

- For share markets it points to a continuation of the volatility we have seen lately, particularly now that we are in the normally weak September quarter.
- It also means the euro will be weak, which along with a weak US dollar on the back of its own debt problems and potentially more quantitative easing all adds up to ongoing demand for hedges, such as gold and commodity currencies like the Australian dollar.

In recent years, Europe has contributed next to nothing to global growth and it's not necessarily the case that intensifying weakness in southern European countries will drag down Germany, which stands to benefit from any weakness in the euro. The emerging world also remains reasonably strong and the US is likely to undertake another round of quantitative easing if conditions darken too much. The real issue would be if it looks like causing a global crisis like the US subprime problems did. While US bank exposures to European public debt are low, the risks are worth monitoring for short-term investors. Key indicators worth watching to see whether the crisis is morphing into another global financial crisis are Italian and Spanish bond yields, economic indicators in these countries along with Germany, money market and credit spreads for signs of panic in lending markets and prices for growth-sensitive industrial commodities such as copper.

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