

European update: Back and forth

Economic research note

12 December 2011

- European leaders have announced further monetary and fiscal policy changes aimed at stabilising the sovereign debt crisis.
- The ECB has eased monetary policy again and will provide longer-term liquidity financing to the banking system. Revised economic forecasts and downside risk suggest further monetary policy easing early in 2012.
- EU leaders made progress in developing a new ‘fiscal compact’ to continue the EU’s path towards a fiscal union.
- In addition, stabilisation and funding resources will be boosted to help ensure indebted nations are able to face their refinancing hurdles in the year ahead.
- While all these measures build on previous steps and have their merit, they are unlikely to be enough to significantly reduce market volatility or provide a more permanent solution to the EU sovereign debt crisis.
- In addition, the ECB leadership, especially from the German perspective, remain opposed to any significant intervention from the ECB and/or Eurobonds.

EU leaders try again

European Union (EU) leaders last week announced further measures aimed at calming markets and putting in place some long-term measures to restore stability and help resolve the sovereign debt crisis.

Although the policy announcements have some merit, at this stage these measures are **unlikely to be enough to reduce financial market volatility, permanently lower sovereign bond yields in peripheral EU countries or move the crisis closer to a resolution.**

Implementation risks, political uncertainty and a failure to address underlying imbalances remain large impediments to a solution.

The announced measures include further monetary easing by the European Central Bank (ECB), taking the cash rate back to 1.0%, and important measures to help provide liquidity to the banking sector.

Politically, the EU leaders announced two major agreements to help stabilise sovereign debt markets; a new ‘fiscal compact’ and measures to enhance the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM).

The new ‘fiscal compact’ aims to strengthen the fiscal and governance framework of eurozone countries. The goal is to move towards a genuine ‘fiscal stability union’.

These longer term reforms of fiscal discipline and the governance framework will be complimented by enhancements to the EFSF/ESM, with the lending capacity of these funds to be increased and with the ESM to be introduced in July 2012 – a year earlier than originally intended.

While these measures are a further step in the right direction, **there is not, as yet, a comprehensive solution to the debt and economic problems in Europe.**

Perhaps most significantly, **the ECB continues to rule out an aggressive bond purchase program that would substantially lower bond yields** and help provide the necessary market conditions to accommodate the large borrowing programs of some nations in the year ahead.



Stephen Halmarick
Head of Investment
Markets Research

Belinda Allen
Senior Analyst,
Investment Markets Research

James White
Senior Analyst,
Investment Markets Research

EU leaders move to a “stronger economic union”

There were two main outcomes to the EU leaders’ summit.

1. Fiscal compact

This agreement should strengthen the fiscal and governance regime surrounding the euro area and imposes a new fiscal rule on Member States. The main proposals include:

- A commitment that general government budgets shall be balanced or in surplus, as a rule this is when the annual structural deficit does not exceed 0.5% of nominal GDP.
- This rule is to be introduced in Member States’ national legal systems at constitutional or equivalent level. The rule will also contain an automatic correction mechanism that will be triggered in the event of deviation.
- These automatic sanctions can be halted by a qualified majority of euro area countries. At this stage there are no details on what these sanctions will involve.
- The European Court of Justice is expected to verify implementation of these measures into national law.
- For those countries in ‘Excessive Deficit Procedure’, i.e. those countries with very high deficits (greater than 3% of GDP) a program detailing structural reforms to improve the situation and yearly budget plans will be monitored by the European Commission and European Council.
- Further, oversight of national budgets prior to implementation will be improved. The European Commission will also be allowed to provide an opinion on these plans and suggest corrective action.

2. Strengthening stabilisation tools

EU leaders recognised that an improved governance regime will only go so far to improve market tensions and that further stabilisation tools were necessary at this stage. These measures include:

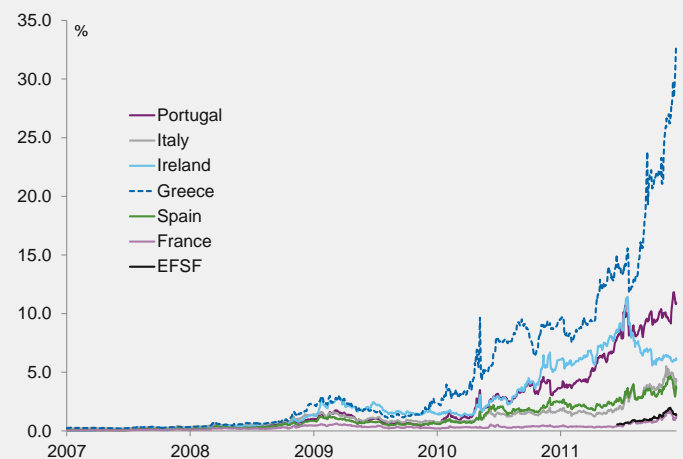
- Bringing forward the permanent bailout fund, the European Stability Mechanism (ESM). This will enter as soon as Member States representing 90% of capital commitments have ratified it with aim to have this in place by July 2012, one year earlier than previously planned. However this aggressive timeframe looks at risk with the likelihood that agreement will be needed by the 27 EU member countries.
- Contrary to market anticipation, or hopes, the ESM will not have a banking license, preventing the ECB from lending to the ESM and effectively leveraging up this instrument.
- At the same time, the EFSF will continue to operate until mid-2013, now allowing for a cross-over between these two funds.
- At this stage the overall ceiling of lending capacity for the EFSF/ESM will be limited to €500bn, but this will be reassessed in March 2012.

- Importantly, there has been a commitment, subject to member agreement to provide additional resources to the IMF, of up to €200bn in the form of bilateral loans (most likely from National Central Banks through currency reserves) to help the IMF have adequate resources to deal with the crisis.
- The hope is that will encourage contributions from the international community (ie. China), given the strong governance arrangements the IMF provides when lending to countries.
- One sticking point centres on changes to the ESM Treaty, introducing an emergency provision of a qualified majority of 85% when the ECB and European Commission conclude that urgent assistance is needed, rather than the previous unanimous agreement.
- Finland will be asking for the Finnish parliament to confirm the change. This once again highlights the political risk surrounding these new measures.

It is significant to note that in 2012 Spain, Italy, Portugal, Greece and Ireland have a combined refinancing need of just over €537bn¹. This total excludes new money required to fund ongoing deficits.

Together, therefore, **the combined firepower of the EFSF/ESM and IMF should be enough to assist in financing this debt if the need arises**, ie. if market interest rates rise to such a level that stabilising debt becomes all but impossible.

10 year bond spread over Germany



Source: Bloomberg. Data to 9 December 2011

Eurobonds

At this stage there has been no decision on the introduction of Eurobonds, ie. a bond issued by a centralised authority, with the money raised then redistributed across the EU region as required.

Germany’s Chancellor Angela Merkel, however, remains strongly opposed to the introduction of a Eurobond. She believes the introduction of Eurobonds would remove the market discipline currently imposed on counties that allow their budget deficits to persistently remain in deficit.

¹ Source, Bloomberg page WCDM

However, the measures announced at the EU leaders' summit continue to focus policies designed to deepen fiscal integration, so as to better reflect a degree of interdependence between the euro countries. A move towards full fiscal union may help the German leadership to change their mind on Eurobonds.

The door, therefore, does remain ajar to the eventual introduction of euro bonds, with a report from the European Commission and European Council due by June 2012 on the feasibility of Eurobonds.

Political and legal uncertainty

There remains, however, division in Europe about the best path for fiscal integration. **The UK has declined to take part in the new 'fiscal compact'**. So instead of the treaty changes being signed by all 27 EU member countries, it will be drafted as an 'international agreement'. It is expected that this will be signed by all countries apart from the UK, although Hungary, Sweden and the Czech Republic will consult their parliament, while Ireland and the Dutch may need a referendum given previous experience of rejecting EU proposals.

It is safe to say that implementation risks for both the stabilisation tools and fiscal compact are large. Question marks surround the ability to enforce automatic sanctions and the right to remove national sovereignty. In particular the German Constitutional Court could pose issues for these changes.

ECB policy easing

On the day prior to the EU Leaders meeting, the Board of the ECB announced a further round of policy easing and support for the banking system.

As widely expected, **the ECB eased monetary policy by a further 25bp, taking the main repo rate back down to 1.0%**. The tone of the ECB's statement was relatively 'dovish' (although the decision to cut rates was not unanimous) and **so further rate cuts below the previously perceived 'floor' of 1.0% should be expected early in 2012**.

Secondly, **the ECB will provide further liquidity support to the banks** by conducting "two (on 20 December 2011 and 28 February 2012) longer-term refinancing operations with a maturity of 36 months and the option of early repayment after one year."

In addition, the banks' reserve ratio will be lowered from 2% to 1%, as the "system of reserve requirements is no longer needed to the same extent as under normal circumstances to steer money market conditions."

Finally, the ECB has increased the collateral available to the banks by "i) reducing the rating threshold for certain asset-backed securities and ii) allowing national central banks, as a temporary solution, to accept as collateral additional performing credit claims, ie bank loans, that satisfy specific eligibility criteria."

What the ECB did not do, however, was provide any further support to the EU sovereigns, ie. there was no sense of a substantially increased SMP and/or direct lending to governments.

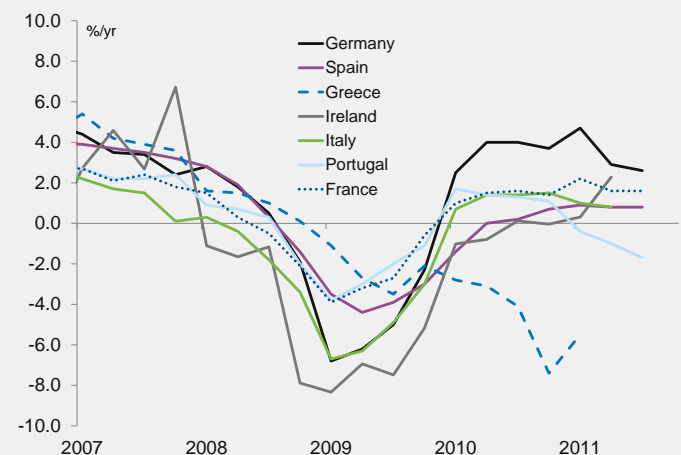
While not mentioned at all in the ECB's written statement, ECB President Draghi was asked about any potential measures in the press conference. His answers always went back to the point that it was **not permissible under the EU Treaty to lend to sovereigns, either directly or via the IMF, and that a substantial increase to the securities markets program (SMP) was the answer**.

It is also important to note comments from the Bundesbank President, and member of the ECB Board, Jens Weidmann, that **"the mandate of redistributing taxpayer money among member states clearly does not lie in monetary policy."** In addition, he stated that "financing of sovereign debt through central banks is and remains forbidden by treaty."

The ECB has also provided its latest economic forecast. For 2012 economic 'growth' is now forecast at a range of -0.4% to 1.0%, with a recovery expected in 2013 to 0.3% to 2.3%. While these forecasts are down substantially from the previous expectations, they are still well above market forecasts, with the consensus at 0.5% in 2012 and 1.55% in 2013.

The ECB also stated, however, that "substantial downside risks to the economic outlook for the euro area exist in an environment of high uncertainty." As shown in the chart below, the pace of economic growth in nearly every EU country is slowing and is expected to slow further in 2012. Indeed, a recession in the EU in 2012 should now be the base case.

EU economic growth



Source: Bloomberg, data to 30 September 2011

On inflation, the ECB notes that the current rate of inflation is a relatively high 3.0%, as at November. However, "looking ahead, they are likely to stay above 2% for several months to come, before declining to below 2.0%."

Indeed, for 2012 the ECB expects inflation to range between 1.5% to 2.5% and then decline to between 0.8% and 2.2% in 2013.

European inflation set to fall



Source: Bloomberg, data to 30 November 2011

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Senior Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Senior Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au
Stephanie Cain	Graduate Analyst	+61 2 9303 2965	scain@colonialfirststate.com.au

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. **Past performance should not be taken as an indication of future performance.**

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them. This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2011) Colonial First State Group Limited.
All rights reserved.