Edition 17 – 12 May 2010
Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP capital INVESTORS

# The euro-zone debt debacle and the global recovery


## Key points

- European authorities have provided a strong lifeline for troubled European countries. This, along with the stronger state of the global economy today, should help prevent the European public debt crisis turning into a re-run of the global financial crisis (GFC).
- Longer term though, public debt crises in advanced countries are likely to remain a recurrent theme.

## Introduction

Late April to early May saw the Greek debt debacle degenerate into a major crisis, with significant contagion to bond markets in other European peripheral countries and a slump in global share markets on worries about a re-run of the GFC. Fortunately, the European authorities appear to have got the message and have provided a strong package of support involving access to funding for troubled European countries and the European Central Bank (ECB) buying public and private securities in the euro-zone. So where does this leave us? Will the European stabilisation package work or is it just a temporary reprieve on the way to GFC Mark II?

## Greece and GFC Mark II

The problems in Greece took a turn for the worst in recent weeks following another upwards revision to Greece's 2009 budget deficit, a downgrade to its sovereign credit rating and more violent strikes; leading to worries that it will end up defaulting. This resulted in an accelerating contagion to other perceived high risk countries and a flight to public sector bonds in countries thought to be safer, such as Germany. This led to sharp falls in share markets, commodity prices and growth-oriented currencies on worries that capital flows and lending would freeze up on concerns about counterparty risk and that this, plus increased pressure for austerity measures across Europe, would threaten the global economic recovery. Many began to fret about a second leg of the GFC. Contagion was arguably starting to become irrational and self-feeding, particularly when it came to countries like Spain and Portugal which have lower budget deficits and public debt levels than Greece. If left to run its course, there was a danger that investor fears about high public debt levels could have spread to France, the UK, the US and Japan, which to date have seen their bond yields remain low.

## Why GFC Mark II is unlikely

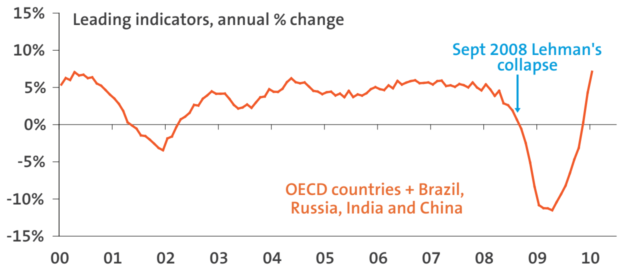
Although the risk of a broader public debt crisis is high, particularly given the now high levels of public debt in many developed countries, the fallout from the Greek crisis is unlikely to be the trigger for anything as severe as what followed Lehman's failure back in September 2008.

Firstly, the amount of debt involved in southern European countries is small compared to the trillions involved in the US mortgage market, particularly once leverage had been allowed for in relation to the latter. The exposures are more transparent this time around and the risks are better understood than was the case for many of the financially engineered investments at the centre of the sub-prime crisis.

Secondly, global monetary policy is very easy today, compared to when the GFC hit.

Thirdly, the global economy is far stronger today than was the case when Lehman Brothers went bust in 2008. Back then, the world was already entering recession and leading indicators of economic growth were in free fall. By contrast, today's global economic indicators point to the commencement of a significant economic upswing. In other words, the global economy is far less fragile than it was two years ago.

**Global leading indicators are much stronger than when Lehman Brothers went bust**




Source: Bloomberg, AMP Capital Investors

Finally, policy makers now appear to be acting more decisively than occurred in 2008. The fact that Europe has not let Greece fail (funds will be disbursed by 19 May to Greece) and the European Commission and the ECB have now adopted a massive policy response indicate they are very keen to get on top of the problem and put an end to irrational contagion.

Uncertainty still remains over parts of the package. The bilateral loans still require parliamentary approval in individual countries, details are lacking about the ECB's bond purchasing plans and the package does nothing about the longer term solvency problems of Greece and potentially other countries (and nor could it). However, the size of the package at €720 billion or US$915 billion indicates the European authorities are serious. The existing package for Greece means it won't have to tap bond markets for three years and so will have little reason to default in the short term. Similarly, the availability of the backstop could remove the need for countries such as Spain and Portugal to have to borrow in the market for the next year or so. If that isn't enough, the commitment of the ECB to buy public sector debt will serve to keep a lid on bond yields. In fact, the announcement of ECB buying saw ten-year bond yields fall by 467 basis points (bps) in Greece, 163 bps in Portugal and 51 bps in Spain. As such, the support packages have helped these and other high-debt countries buy time to make some progress in cutting their deficits.

## More like the Asian crisis of 1997-98 than the GFC

The outworking of all this is that a re-run of the GFC is unlikely. The more likely scenario is that it will unfold somewhat like the Asian crisis in 1997-98, which saw sharp economic and share market slumps in key Asian countries but global growth continued. While the Asian crisis contributed to sharp corrections in global shares in October 1997 and July-August 1998, the global bull market continued. Moreover, just as the Asian crisis in 1997-98 led to easier than otherwise monetary policy globally and helped fuel the tech bubble, it's likely the current crisis will have the effect of keeping global interest rates lower for longer, which could provide a strong boost for investment markets once the uncertainty starts to abate.

## Implications

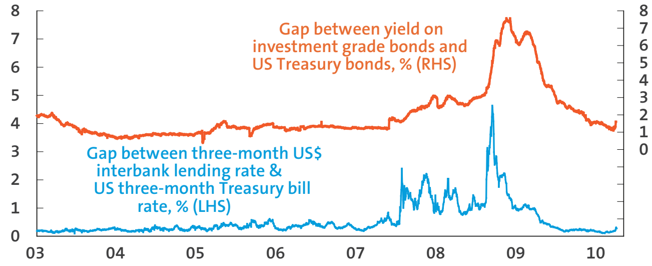
There are a number of implications from the European stabilisation package and tough austerity programs in several peripheral countries:

- The spreads between bond yields in Greece, Portugal and other problem countries versus German yields are likely to remain well below recent highs, reflecting the borrowing facility and the commitment by the ECB to buy public sector bonds.
- Fiscal tightening in southern Europe combined with more liquidity injections by the ECB will likely ensure interest rates in Europe remain lower for longer.
- While the euro is oversold and due for a bounce, its broader trend is likely to remain down on the back of a relatively easier monetary outlook compared to the US, a weaker euro being necessary to relieve the pressure on troubled countries, and ongoing concerns about the long-term viability of the common currency.
- Deepening recessions on the back of fiscal austerity in Greece and other peripheral countries are likely to maintain downward pressure on their share markets. Falls of 55% or more for Thai, Indonesian and Korean shares during the Asian crisis suggest Greek and Spanish shares have more downside.
- By contrast, German and northern European share markets are likely to benefit from the weak euro and easy monetary conditions.
- If the package is successful in stabilising the public debt situation in Europe, it should help to contribute to a recovery in global share markets once the dust settles from the current correction. However at this stage, even though price to earnings multiples have fallen to low levels, e.g. 12.3 times in Australia versus a long-term average of 14.5 times, it's still too early to say the correction in shares is over, particularly with concerns about Chinese tightening continuing to rattle investors.

## What are the risks and what to watch?

In the short term, the main risk is the European package is insufficient to stem contagion or its introduction is half-hearted and drawn out (as we saw with the Greek package). Key to watch here would be bond yield spreads between troubled country debt and German yields and credit and money market spreads (as indicated in the next chart) for signs of a return to a global credit crunch. So far the impact has been minor.

**Watch credit and money market spreads – so far they are well below 2008 extremes**




Source: Bloomberg, AMP Capital Investors

German business conditions indicators are worth keeping an eye on to see whether the continuing turmoil in southern Europe is having much impact.

Longer term, the key issue for Greece and other troubled countries is one of solvency. While the European support package addresses concerns about such countries' access to funding (i.e. liquidity) over the next few years or so, bringing the deficit and debt under control will be very hard, particularly in Greece. Its public debt to gross domestic product ratio will continue to rise for many years to come, even as it cuts its deficit. So while there is no incentive for Greece to default in the next few years, it remains a longer term risk.

More broadly, the Greek public debt crisis has fired a shot across the bow of major counties such as France, the UK, the US and Japan, all of which have problems with public debt. While they are arguably in better shape than Greece and have been given some breathing space by the European support package, they will nevertheless have to start bringing their budgets back under control next year as private sector growth starts to become more sustainable. This in turn will result in several years of constrained growth in advanced countries.

## Conclusion

The public debt crisis in Greece and other countries is unlikely to signal the start of another round of the GFC. Moreover, the European support package has likely provided a bit of breathing space to troubled economies. However, it provides a longer term reminder that high public debt levels will be a key constraint on major advanced countries in the years ahead as well as being a key risk factor to keep an eye on.

**Dr Shane Oliver**
**Head of Investment Strategy and Chief Economist**
**AMP Capital Investors**

## Contact us

**If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:**

| | |
|---|---|
| Financial Advisers | Your Business Development Manager or call 1300 139 267 |
| Private Clients | Your Financial Adviser or call us on 1800 188 013 |
| Wholesale Investors | AMP Capital's Client Service Team on 1800 658 404 |