

European authorities step up

Economic research note

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- While the EU sovereign debt crisis is still far from resolved, the package of measures announced by the EU Leaders is a major step-up in their determination to return to financial stability.
- A series of measures will provide further funds to Greece at a lower interest rate and longer maturity that will help stabilise Greek debt in the years ahead.
- In addition, the EFSF will gain new powers to intervene in government bond markets right across the EU and, significantly, to provide funds to help support the banking system.
- A number of private sector banks have agreed to a known and voluntary 'haircut' on their Greek bond holdings that should also help stabilise financial markets in a more controlled way.
- Finally, the EU Leaders are also focused on restoring economic growth across the region and reforming their institutional framework to both respond to and avoid crisis in the future.

European authorities step up:

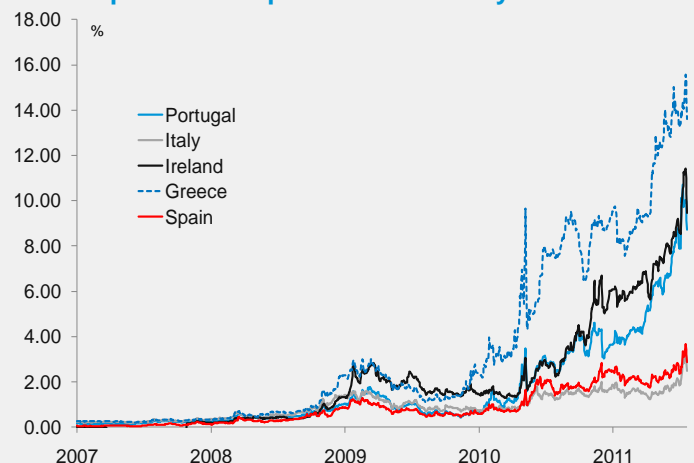
While it certainly would seem premature to conclude that the European (EU) sovereign debt crisis has been 'solved' the package of measures announced by the EU overnight does represent a significant step-up in the authorities determination to return a number of EU countries to financial stability.

Markets have (for now at least) responded positively to these developments, with bond spreads narrowing, equity markets rallying and the EUR strengthening. However, plenty of things could still go wrong yet, with implementation risk a real possibility, agreement among all nations not yet certain, further credit downgrades possible and with financial markets likely to remain volatile as the agreement is implemented.

In the short-run, also, the economic data out of the EU looks to have turned down, while ongoing monetary and fiscal policy tightening across the region will likely act to slow growth over the medium-term.

Notwithstanding all this, however, as noted above, one could imagine that overnight developments in the EU do represent a significant change in momentum and that some stability could be restored to this important region of the world in the months ahead.

European bond spreads to Germany



Source: Bloomberg



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The EU package in detail:

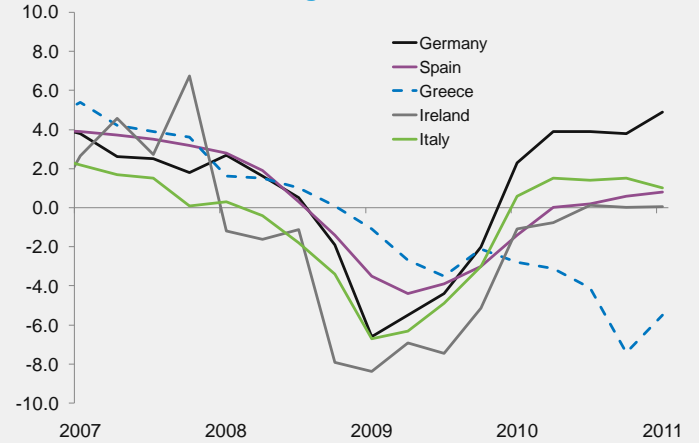
The statement released by the Heads of State of the EU overnight details a 16 point package to restore financial stability to the region.

The first 5 points of the statement deal specifically with Greece as follows.

Greece:

1. The EU authorities will retain pressure on Greece to fully implement its fiscal austerity plans, describing them as “unprecedented, but necessary, efforts to bring the Greek economy back on a sustainable growth path.”
2. Together with the IMF and a ‘voluntary’ contribution from the private sector (see below for details), the EU authorities will provide an estimated EUR109bn for Greece, an amount which is expected to cover their borrowing needs out to 2014. These funds will be provided through the European Financial Stability Fund (EFSF).
3. The maturity of the EFSF loans to Greece will be extended from the current 7.5 years to a minimum of 15 years and up to 30 years. The interest rate on these loans will be cut to 3.5% (from 4.5% currently), with the rate in the future to remain “close to, without going below, the EFSF funding cost.”
4. The EU authorities will work with Greece on a “comprehensive strategy for growth and investment in Greece.” The European Investment Bank (EIB), originally established to help the poorer eastern European nations, will be involved in this process. As shown in the chart below, this should help the Greek economy recover some of its lost ground and hopefully begin to grow again in the years ahead.
5. Through a number of voluntary options the private sector will contribute an initial EUR37bn of support for Greece. Full details on this private sector involvement are provided below. In addition the EU authorities will provide credit enhancement to Greek debt to “underpin the quality of collateral so as to allow its continued use for access to the Euro system liquidity operations by Greek banks.” The EU authorities also committed themselves to “provide adequate resources to recapitalise Greek banks if needed.”

Selected EU economic growth rates



Source: Bloomberg

The private sector and Greece:

On the issue of private sector involvement, the EU authorities made it clear, through points 6 and 7 that Greece was a ‘special case’, stating that:

6. “As far as our general approach to private sector involvement in the euro area is concerned, we would like to make it clear that Greece requires exceptional and unique solution”.
7. In terms of the other countries within the EU they make the statement that “all other euro countries reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms.” This seems very clear – the market of course, will be hoping that it turns out to be the case.

Stabilisation:

In terms of stabilising the EU financial systems and sovereign debt beyond Greece, the Leaders also made two key commitments.

8.
 - a) The EFSF and its planned successor, the ESM (European Stability Mechanism), will be allowed to “act on the basis of a precautionary program”, meaning they can get involved before a problem with any country if it gets too out of control.
 - b) The EFSF/ESM will be able to “finance recapitalisation of financial institutions through loans to governments, including in non-program countries.” This means that not only can the EFSF support sovereigns, but also will be involved in recapitalising any banks that come under stress, whether those banks are in countries being supported by the EFSF or not (such as the Spanish ‘cajas’, or mortgage lenders) – this is a major step in providing a mechanism to ensure the EU sovereign debt crisis does not become a much larger banking crisis.

- c) The EFSF/ESM will be allowed to intervene in both the primary and secondary sovereign bond markets. Such bond purchases would be on the basis of the ECB (European Central Bank) “recognizing the existence of exceptional financial market circumstances and risks to financial stability.” So essentially the EFSF/ESM will be able to remove sovereign debt that is under extreme pressure from the markets (one assumes on a permanent basis), taking them out of the private sector and into the hands of the public sector.
9. To ensure that other EU countries are not placed under market pressure from providing their share of funds to the bail-outs of Greece, Ireland or Portugal the EU Leaders agreed that “a collateral arrangement will be put in place so as to cover the risk arising to euro area Member States from their guarantees to the EFSF.”

Fiscal consolidation and growth:

In terms of the ongoing need for both fiscal consolidation and economic growth in the EU, the Leaders made the following points:

10. Both Ireland and Portugal are expected to continue their fiscal austerity programs. In return for this commitment “the EFSF lending rates and maturities agreed for Greece will be applied also for Portugal and Ireland.” This means that Portugal and Ireland will now get a substantial reduction in their interest rate to 3.5% and an extension in their debt maturity. This should greatly assist both countries to stabilise their debt levels.
11. By 2013 ‘at the latest’ all EU countries that are not under EFSF programs (ie. everybody except Greece, Portugal and Ireland) will have a budget deficit below 3% of GDP. Special mention was made of the recent fiscal package in Italy which will see a budget deficit below 3% of GDP in 2012 and a balanced budget in 2014. Spain also gets a special mention of support.
12. The EU supports measures to improve economic growth, through reforms and better coordination between the various European bodies.

Governance:

In terms of economic governance to ensure implantation of the EU programs:

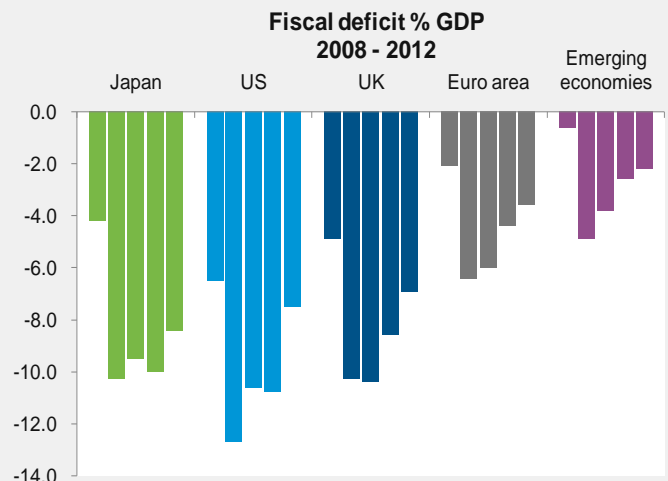
13. The Leaders are looking for rapid agreement and legislative progress on the strengthened Stability and Growth Pact, which will also be put through the European Parliament under the Polish Presidency.

14. Significantly, the Leader agreed to introduce, by the end of 2012, a national fiscal framework. This should go a long way to improving the co-ordination and consistency of budget policy across the EU, helping to stabilise the monetary and currency union.

As shown in the chart below, if the EU was to move to a real fiscal union, its combined budget deficit position would be much lower than the US, UK or Japan.

15. In another significant development, the role of the credit rating agencies looks like it will continue to be downgraded (no pun intended), with the Leaders stating that “we agree that the reliance on external credit ratings in the EU regulatory framework should be reduced.”
16. Finally, in a further attempt to bring all the various EU authorities closer together, a deadline of October has been set for “concrete proposals on how to improve working methods and enhance crisis management in the euro area.”

Budget deficits across the world



Source: IMF

Private sector involvement:

In terms of the private sector involvement of the funds available for Greece, the Institute of International Finance (IIF) has proposed what they call a ‘Financing Offer’. This has been supported by 30 banks across Europe and the UK, with institutions from Canada, Turkey, Peru, Kuwait and Korea also included.

The IIF states that, along with the contribution from the EU authorities and the IMF that the financial institutions nominated “are prepared to participate in a voluntary program of debt exchange and a buyback plan developed by the Greek government.”

“In summary, the program involves an exchange of existing Greek government bonds into a combination of four instruments together with the Greek Debt Buyback Facility.”

The four instruments made available will be i) a par bond exchange into a 30 year instrument, b) a par bond offer involving rolling-over maturing Greek government bonds into 30 year instruments c) a discount bond exchange into a 30 year instrument and d) a discount bond exchange into a 15 year instrument.

For the first three instruments the principal will be fully collateralised by 30 year zero coupon AAA rated bonds. For the fourth instrument this will be partially collateralised through funds held in an escrow account.

It is assumed that the private sector bond holders will participant at a rate of 25% into each instrument.

In addition, and significantly, "all instruments will be priced to produce a 21% Net Present Value (NPV) loss based on an assumed discount rate of 9%."

This part of the debt deal could, therefore, be classified as a type of controlled 'haircut' on private sector holding of Greek sovereign debt. The EU Leaders expectation is, however, that because the loss in NPV is known and voluntary that it will not place undue pressure on the banks involved.

There is clearly a risk here, however, that the credit rating agencies will take this action as a default, and will act accordingly.

A further risk is that markets assume that this will be the template that eventually needs to be applied to Portugal and Ireland and perhaps other countries not yet accessing funds via the EFSF program. Under this scenario further downgrades in the credit ratings of these countries could occur.

Importantly, however, the four instruments that will be made available to the private sector will have the effect of significantly reducing the interest rate Greece will pay on its debt outstanding, with lower interest rates at the start and increasing over time, while also increasing the average maturity of debt outstanding from 6 years to 11 years.

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