

a closer look at European debt

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Barely a day has gone by in the past few months without the political, economic and social turmoil in Europe hitting the headlines. This unrest has impacted on world financial markets. A lack of confidence in the ability of European policy-makers to effectively address the issues has meant that investors have favoured defensive investments such as bonds and bank deposits in countries with high credit ratings.

In this *insight*, we look more closely at events in Europe. We look at the implications for client portfolios and explain how we are responding.

what is the background to the current issues facing Europe?

Currently, 23 European countries use the euro as their unit of currency. The reason why this difficult situation has emerged is that in many ways, **the Euro currency zone is a half-built system**. The currency zone has a common monetary policy, administered by the European Central Bank, but it does not have a common fiscal policy.

what are monetary policy and fiscal policy?	
monetary policy	fiscal policy
policies carried out by a central bank that aims to influence growth and inflation trends by altering the cost and availability of money	government policy that aims to influence the growth, inflation and the distribution of wealth in an economy through taxation, welfare payments and government spending

Some countries, such as Greece and Portugal, borrowed more money than they could afford to repay.

Originally, the creators of the Eurozone thought that monetary union would lead over time to fiscal union. This did not occur and the governments of certain countries did not behave with the required fiscal prudence. Each country was free to spend, collect revenues and borrow without reference to other member states. Limits on budget deficits and government debt were established but there was no effective mechanism to police them.

Some countries, such as Greece and Portugal, were able to access more debt than they had previously been able to because they were now part of the Eurozone. The private banking sector in Ireland and Spain also borrowed excessively. This meant that after the GFC, a number of European governments issued large amounts of debt when they had to rescue their private sector banks, support their economy and meet other spending commitments. Over the past two years, investors began to worry whether some of the countries were in a position to service their debt.

As this has become an increasing concern for lenders, they have begun to push up the interest rates that these countries have to pay on their debt. A number of countries have seen their bond rates rise steeply. That means that the cost of rolling over debt has become increasingly unsustainable. These high interest rates are manageable for a while but if they persist then they will strangle the economy and make it harder for these countries to grow enough to repay debt. This has made the debt dynamics of some countries even more precarious.

A number of European banks that have invested in problem government bonds now also find themselves in a difficult situation. European financial regulators also required banks to hold sovereign bonds as loan reserves. Some lenders to banks fear that the banks will not be able to service their own borrowings and are less willing to lend to them.

Countries such as Germany are in a relatively good position because they have a culture of maintaining fiscal discipline.

why are some countries in a good position while others are suffering?

Countries such as Germany are in a relatively good position because they have a culture of maintaining fiscal discipline. This requires both a robust tax system and diligence in the control of government spending. Importantly, they also have a very strong work ethic, which has enhanced competitiveness.

In an economic system with free-floating exchange rates, the currencies of different countries would appreciate or depreciate to even out this competitive advantage or disadvantage. Said another way, if Greek products cost relatively more to produce compared to German products, the Greek currency would fall to a level where everyone would pay approximately the same for Greek and German goods.

The Eurozone countries are part of the same single currency union so the currency adjustment mechanism does not exist. Instead, what was expected was that labour and capital would move to where it was most productive. Each country would then focus on producing what it has a relative competitiveness in doing. As an example, Greece would focus on tourism and Germany would build cars. In Europe, one could expect workers to move from Greece to Germany, thereby changing the relative competitiveness of both countries. In reality, labour has not moved as much as is needed, mainly due to language barriers, significant cultural differences and family ties.

why have politicians let things get to this stage?

The ultimate resolution will probably see the richer countries like Germany share some of the burden in repaying debt incurred by the more fiscally challenged countries, such as Greece.

The reason it will take a long time to reach this end game is because for a politician in Germany to agree quickly to such a solution would be politically damaging. The German politician has to be seen (by the taxpayers who have elected them) to be extracting their 'pound of flesh' from problem countries rather than simply rolling over and agreeing to help. This requirement to be 'tough' on the debtors is important because it reduces 'moral hazard', which occurs when borrowers believe they will not have to repay their debts and therefore act recklessly.

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This complicated political dimension means that politicians will delay making decisions until the last possible moment. This is bad economically because of the increased uncertainty, but politically, it is a rational decision if the politician in question wishes to appear tough rather than agreeing quickly and looking weak.

At a certain point, it becomes rational for politicians to get a deal done because the economic costs of failing begin to outweigh the political benefit of being seen as driving a hard bargain.

why are some countries making progress while others are not?

Countries like Ireland have made good headway in tackling their debt problems. This has been reflected in a lowering of the interest rates they have to pay for borrowing.

Ireland has a well-developed tax system. They can increase tax rates and enforce tax collection. Countries like Greece, with a poorly developed tax system, have found it harder to enforce compliance let alone meaningfully broaden their tax base.

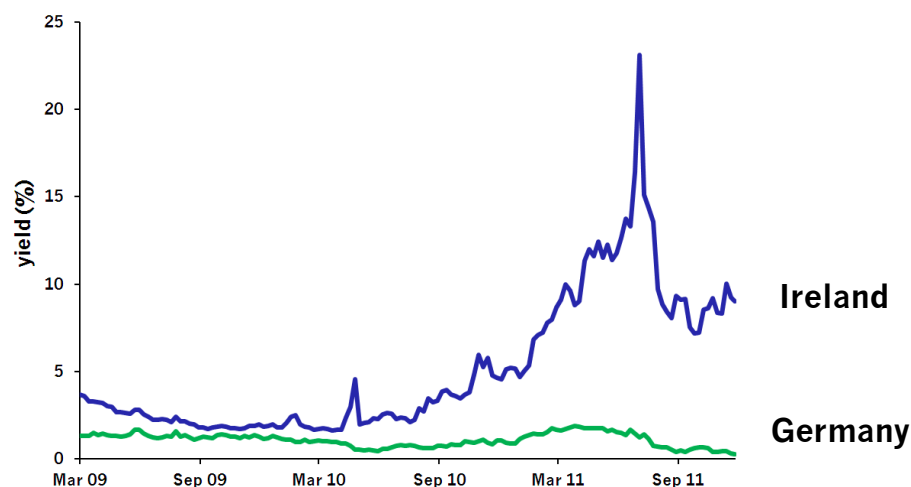
The political composition of countries is also important. A weak coalition government has much less leeway to take tough policy actions than a government that has a mandate, through elections, to implement its policies.

In Ireland, in February this year, a parliamentary election saw the previous government swept out of power. The victorious, incoming government had a mandate

to fix Ireland's problems. This political stability has had a positive impact on Ireland's debt yields, which have fallen in recent months.

Political stability and a mandate for change has helped Ireland.

Ireland's bond yields have fallen as investors gain confidence



Source: Bloomberg. Data at 30 November 2011.

what is the solution to Europe's problems?

The situation in Europe is unique and new. Policymakers find themselves in uncharted waters. This makes predicting what the future looks like very difficult. Observing the market's reaction to the evolving situation is straight forward because bond yields are visible. This is in contrast to the beginning of the GFC, when the magnitude of the issues was initially not as quantifiable because transparency on the issues was low.

While there is no easy solution, a two-pronged approach, with shorter-term agreements on debts already incurred coupled with the longer-term creation of a common fiscal policy or union, is one pathway ahead.

A fiscal agreement would have to be administered by a central body similar to the European Central Bank. Enforcement would appear to require severe penalties when there were breaches. In recent days, we have seen policy-makers agree that a common fiscal policy is a prerequisite to solving the eurozone's difficulties.

To ensure European banks continue to function normally, providing essential financing for the economy, it may be necessary for governments to assist in their recapitalisation to improve the strength of their balance sheets.

how have ipac's appointed managers responded in the situation?

In our portfolio asset allocations, we have maintained a preference for Australian bonds over global bonds in the Government Bonds sector. In the global bond sector, ipac's fixed interest managers have positioned the portfolios defensively. This has been achieved by increasing exposure to higher rated counties, like Germany.

The prudent approach of our fixed interest managers, means that we do not hold Greek debt. This reflects the managers' views that the risk of permanent loss is too high to make Greek debt attractive, despite the high yields on offer.

ipac's managers in the fixed interest corporate bond sector have been enhancing the credit quality of holdings by moving towards companies that have strong balance sheets combined with earnings that come from multiple countries.

Our portfolio asset allocations have maintained a preference for Australian bonds over global bonds.

Our share managers believe that because of the deep uncertainty prevailing at present, it is better to adopt a cautious approach.

Our forward-looking, fundamental shares managers take into account many variables including interest rates and economic and company growth rates. In this environment, they have become more cautious and defensive, despite the compelling valuations. On balance, our share managers believe that because of the deep uncertainty prevailing at present, it is better to adopt a cautious approach. However, they remain ready to capture opportunities as the future becomes clearer. Managers are focusing on quality companies with low debt and good diversity of earnings.

ipac's portfolio positioning is summarized in the table below

overweight	underweight
high quality government bonds - Australia, core Europe, US and UK	peripheral European country debt - no Greek exposure
corporate debt with high credit ratings	reduced exposure to lower credit rating corporate debt
high quality, international shares in companies with strong balance sheets and geographically diversified earnings	highly speculative shares especially those in problem European countries
foreign currency exposure increased for diversification and return benefits	
cash holdings increased - taken from reducing global smaller companies	global smaller companies share allocation reduced

what does ipac think about the outlook for growth assets like shares?

ipac believes that share prices have already accounted for the majority of the uncertainty. Prices have already factored in the bad news. From here, much depends on the actions of politicians and how they go about developing a lasting solution.

Our scenario testing leads ipac to view the probability of a positive outcome as higher than other less positive outcomes.

If politicians again found it difficult to reach agreement and this severely impacted confidence and growth prospects, increased investor anxiety could further dent markets. However, if politicians move towards agreement then there is the potential for growth assets to increase in value.

what is ipac's view?

Our scenario testing leads ipac to view the probability of a positive outcome as higher than other less positive outcomes. In ipac's judgement, the probability is very good that over the next 3-5 years returns from shares will be above average as the debt issues subside. For this reason, it makes good sense to remain invested.

if I have shifted away from growth assets, when should I re-enter the market?

The dilemma faced by investors who have sold their growth assets is that at some point they will have to make a decision about re-purchasing those growth assets. Unfortunately, it is very likely that reluctance to reinvest until the recovery is confirmed will mean that the lucrative early days of the recovery will be missed. Missing these vital few days can radically alter your ultimate investment outcome.