# Europe: Painful Today For Well-Heeled Tomorrow

In our earlier article, "Euro-zone: All izz well" during midst of possible PIIGS fallout, we debated that while things were not hunky-dory, they were not apocalyptical either, as was being projected by the media. We debated that the serious structural reforms undertaken would boost investor's confidence and would bring yields to more realistic levels.

Today, we can see things getting back to more rational level. Even though the journey has just begun with miles yet to go, there have been quite a few encouraging developments. UK's economy has gained significant traction prompting BOE to vote against further Quantitative Easing in the country. Also, the troubled Euro zone countries now seem to be on the right path, finding their way out of the woods. These developments are a result of number of serious but politically difficult steps taken under the aegis of IMF and ECB, and are gradually but definitely bringing EU back on track. The most impacted countries like Greece, Portugal, Spain and Ireland have also been able to take politically unpopular austerity measures like pruning government expenditure, increasing taxes, pension & benefit reforms and other structural reforms that might be a drag on growth in short run but a lower debt burden would eventually help the economy grow must faster. The optimism can be seen from the market sentiments, with yields on the bonds of Portugal, Spain, and Greece coming down and distant recovery being forecasted in IMF forecasts of GDP growth. Moreover, these countries only combine for about 6% of the bloc's GDP, meaning even deep downturns wouldn't affect the regional average much for growth or inflation. Germany, which has relied on structural reforms, has come out through this crisis unscathed as can be seen in its surging exports. Other European nations are following Germany's example to recover from the mess they find themselves in. Internal German demand for goods is also expected to drive exports of some European countries.

The limited refinancing requirement of European countries adds further to the comfort factor. Greece was sufficiently funded during the bail-out, so it does not need to borrow for several years. Portugal and Ireland also don't have any borrowing needs for next 6 months. There is enough time for them to show some economic growth or fiscal discipline to build credibility for the future borrowing.

Further with the second round of QE in US, increased inflows in some of the Euro Zone nations can be expected, marking a recovery in asset prices in the region. With the growing global savings and current account surpluses already competing for US Treasuries, the additional liquidity created by QE2 is expected to make US Treasury yields uninviting. We see yield starved investors to increasingly invest in these European countries, thus enabling quicker recovery in these countries.

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# Europe: From Short-term Pain to Long-Term Gain

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**November 10, 2010**

European sovereign debt crisis and its handling mechanism are proving to be case studies in crises management for economists, politicians and all the interested onlookers. On one side, we have US, which is injecting liquidity in the system through Quantitative Easing, and on the other side, we have Euro member countries adopting fiscal tightening as a means to balance budget. Monetary policy for Euro zone countries is controlled by European Central Bank (ECB). As a result, Euro zone countries have no control on the supply of Euro. They have to resort to fiscal policies and structural reforms to control their economy.

Indiscriminate spending by the local European Governments in the past triggered Euro zone sovereign debt crises. For many countries, budget deficit as a percentage of GDP is way higher than 3% mandated by ECB. Ireland's budget deficit, expected to surpass 25% of GDP this year, is the biggest in the 16-nation euro area. The possible doubling in the deficit, which is now about 12% of GDP, is due largely to the cost of bailing out its most troubled bank; Anglo Irish Bank Corp. Greece's 2009 budget deficit is likely to be raised beyond the current estimate of 13.6% of gross domestic product. Spain reported a budget deficit equal to 11.2% of gross domestic product in 2009. Portugal's budget deficit was 9.3% of gross domestic product in 2009. Given the indiscriminate spending by the local Governments in Europe, the International Monetary Fund has advised the subject European countries to reduce their budget deficit by adopting austerity measures. These measures are bound to increase unemployment and cut growth in the short term but over the long run lower public debt levels would reduce interest rates and stimulate private investment. The IMF said consolidation equal to 1% of gross domestic product typically reduces growth by 0.5%, raises the unemployment rate 0.3 percentage points and sees consumption and investment fall by 1%. But over the long run, for every 10-percentage-point fall in debt-to-GDP ratios, output rises by around 1.4%.

Those European countries responsible for the sovereign crises have already started taking austerity measures according to IMF's recommendation. To deal with a massive financing bill beyond 2012, Greece, which triggered financial crises, is putting in place a sweeping economic overhaul, including fiscal consolidation and financial-market changes. Earlier this month Chinese Premier Wen Jiabao, on a visit to Greece, said China will continue to buy Greek bonds and announced the creation of a $5 billion fund to help Greek shipping companies buy Chinese ships. Bond markets saw the move as a vote of confidence by a powerful sovereign wealth fund, which has driven yield and spreads on Greek bonds lower. Greece sold €1.17 billion ($1.62 billion) of 26-week Treasury bills with a yield of 4.54%. In September 2010, the government paid a yield of 4.82% at a similar auction. Greek Finance Minister George Papaconstantinou said the government has received broad interest from companies within and

outside Europe in taking partial or complete ownership of state-run operations up for privatization as Athens tries to right a struggling economy. That builds on interest from other countries, such as China and the United Arab Emirates that are already investing in Greece. At least one big postal company in Europe has expressed "explicit" interest in Greece's postal service.

Portugal too has embarked on austerity path. Portuguese government's proposed budget proposal includes an increase in the rate of the value-added-tax to 23% from 21% and wage cuts for public workers. The government expects gross domestic product in Portugal to recover by 1.3% this year, but the harsh austerity measures included in the proposal will contribute to a slowdown in GDP growth to 0.2% in 2011 because the measures will have an effect on domestic demand. In September 2010, Portuguese Prime Minister José proposed a series of harsh austerity measures for this year and next, aimed at cutting Portugal's budget deficit from 9.3% of gross domestic product in 2009 to 7.3% in 2010 and 4.6% in 2011. The goal is to reduce the spending gap to 2.8% of GDP in 2013. However, Portugal's main opposition has not yet agreed to the proposed austerity measures that include spending cuts and new taxes, instead arguing that the austerity measures should consist only of spending cuts.

The collapse of decade long housing boom has resulted in recession in Spain, which has unemployment rate of 20%. In the first two quarters of 2010, Spain's economy showed mild growth after contracting for six consecutive quarters. Spain plans to cut its budget deficit, which is forecast to be 9.3% in 2010, 6% in 2011 and 3% in 2012. Spain plans to achieve it by committing to economic reform and fiscal austerity. Spending cuts at its ministries by 15% to 16% in 2010, overhaul of labor laws are some of the measures Spain plans to take.

Ireland is probably struggling a little more than any other non-bailout European nation as it tries to recover from one of Europe's messiest real-estate busts, which has left its banks awash in souring loans to property developers that likely won't be paid. The International Monetary Fund expects Ireland's economy to contract by 0.5% this year, before growing 2.3% next year. Exports fuel about 50% of Ireland's economy, but U.S. and Britain, two of Ireland's biggest trading partners are experiencing a slowdown. Spending cuts and tax increases may not be enough to protect €1.7 billion of riskier bonds issued by Anglo Irish Bank and investors might have to take a haircut. Ireland is expected to stagnate for the next two years in view of tough austerity measures.

The IMF said economies in Eastern Europe will grow by 3.9% in 2010 and 3.8% in 2011, having contracted by 6% last year. The Fund said it expects Poland's budget deficit to rise to 7.4% of gross

domestic product in 2010, up from 7.1% last year, before falling to 6.7% of GDP in 2011. In emerging Europe as a whole, it expects budget deficits to fall to 5.2% of GDP this year and 4.2% of GDP next year from 6% in 2009.

In the U.K, the Bank of England undertook Quantitative easing during the financial crises of 2008-2009 and now owns 21.9% of the gilt market, with banks and building societies owning another 8.3%, held largely for liquidity purposes. However, UK won't undertake QE2 and has instead planned $127bn in spending cuts over four years that will help pare a budget deficit of £155bn. UK hopes that the Government spending cuts will result in lesser crowding out of private sector spending as lending rates will be low.

An interesting case, however, is that of Germany. A decade before the creation of Euro, Germany suffered from a lack of competitiveness for its products, partly because of pre-euro-entry devaluation and partly due domestic inflation created by post-unification boom. Germany could not control Euro and hence could not control its nominal exchange rate. However, Germany realized that it can improve its competitiveness by reducing the domestic inflation. Reduction in domestic inflation with respect to the inflation in your export markets causes the real exchange rate to depreciate and make your products more competitive than the products available domestically in the export markets. Germany reduced inflation by bringing down unit labour costs thus providing an opportunity for exporters to reduce price. German Government achieved this by working with the labour unions. During the recent recession, 1.5 Mn German workers were flexible enough to work for shorter hours and reduce costs. Exports surged and current account deficit of $24bn in 1991 turned into surplus of $163bn recently. According to IMF estimates, 2010 figure is expected to be $200bn. German exports account for 48% of GDP. Germany's domestic demand has not yet increased as much as expected but if it does, it can pull other Euro nations, such as Ireland, out of recession as imports would increase. Germany can be the engine that can pull Europe out of the trouble it finds it finds itself in. It is important to understand that Germany achieved this renaissance through tough structural reforms in the labour markets. The political will combined with good economic rationale often results in good economic performance. Other European countries are taking steps in this direction by cutting wages to get more competitive in global markets. As in the case with Germany, structural reforms will take time to bear fruit but the end result will make these countries more competitive.

Countries such as Greece, Ireland and Portugal at the centre of the euro zone's fiscal crisis only combine for about 6% of the bloc's GDP, meaning even deep downturns wouldn't affect the regional

average much for growth or inflation. At the moment, it seems that troubled European countries are taking the right path. Markets have also been patient enough to understand that improvement in European economy can take place only in the long term and hence are not expecting any immediate results. Proof of this can be seen in the fact that the long term peripheral bond yields have not risen from their elevated levels in wake of some recent events. There is definitely short term pain in store for some of the European nations but eventually they will prosper in the long term as they have taken the pill of fiscal discipline that IMF has been recommending.

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The scale if from 1 to 5 with 5 being the best.

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