European Debt Crisis 101

Economic & financial market issues

- **The on-going saga that is the European debt crisis has sent investors heads spinning. With all the focus on debts and deficits, many investors rightly want to know what that has to do with us in Australia. And then there is the attention devoted to bond yields – hardly mainstream for most investors.**
- **There are no easy answers to the issues facing European countries. Simply they need to get their financial houses in order. And governments must convince investors, rating agencies and institutions like the International Monetary Fund and European Central Bank that they are taking the necessary measures to stabilise, and ultimately address the problems they face.**
- **This article seeks to outline the key issues as simply as we can while also presenting the basics of bond yields.**

The big picture

- The countries that sparked the European debt crisis (EDC) are not the biggest in the world. Greece is ranked the 34th largest economy with Portugal the 43rd largest and Ireland ranked 45th. But the stakes have been raised with the focus on the world's 8th largest country – Italy – together with Spain, ranked 12th.
- Still it is important to note that China and India together are bigger than the entire Euro area in size – actually they overtook the region three years ago. And China & India together are now bigger than the US and are about the same size as the European Union (in purchasing power parity terms).
- In terms of contribution to world economic growth, China is the most important followed by the US and India. And Hong Kong, Singapore, Taiwan and South Korea together will make a bigger contribution to world economic growth this year than Germany.
- So why the fuss about Europe? Fundamentally it is all about contagion. If Greece can't repay its debts then this would affect European banks and the shockwaves would be felt across the globe. But it is worth pointing out the respective size of the countries involved and their importance to global economic growth. Fundamentally the world would be in bigger trouble if China or India were to get into difficulties.

MAJOR WORLD ECONOMIES
Purchasing Power Parity, US dollars (billion)

	Country	2011		Country	2011
1	United States	$15,065	31	Denmark	$349
2	China	$6,988	32	Thailand	$339
3	Japan	$5,855	33	Colombia	$321
4	***Germany***	$3,629	34	***Greece***	$312
5	***France***	$2,808	35	Venezuela	$310
6	Brazil	$2,518	36	***Finland***	$271
7	United Kingdom	$2,481	37	Singapore	$266
8	***Italy***	$2,246	38	Malaysia	$248
9	Russia	$1,885	39	Nigeria	$247
10	India	$1,843	40	Hong Kong SAR	$247
11	Canada	$1,759	41	Israel	$245
12	***Spain***	$1,536	42	Chile	$243
13	Australia	$1,507	43	***Portugal***	$242
14	Mexico	$1,185	44	Egypt	$232
15	Korea	$1,164	45	***Ireland***	$222
16	***Netherlands***	$858	46	Czech Republic	$220
17	Indonesia	$834	47	Philippines	$216
18	Turkey	$763	48	Pakistan	$204
19	Switzerland	$666	49	Romania	$185
20	Sweden	$572	50	Algeria	$183
21	Saudi Arabia	$560	51	Kazakhstan	$180
22	Poland	$532	52	Qatar	$173
23	***Belgium***	$529	53	Kuwait	$171
24	Taiwan Province of China	$505	54	New Zealand	$169
25	Norway	$479	55	Peru	$168
26	Islamic Republic of Iran	$475	56	Ukraine	$163
27	Argentina	$435	57	Hungary	$148
28	***Austria***	$425	58	Vietnam	$122
29	South Africa	$422	59	Bangladesh	$115
30	United Arab Emirates	$358	60	Iraq	$109

Source: IMF, CommSec. Eurozone members in bold

Craig James – Chief Economist (Author)
(02) 9118 1806 (work); 0419 695 082 (mobile), (02) 9525 2739 (home) | craig.james@cba.com.au; Twitter: @craigjamesOZ

The European Debt Crisis

- It wasn't that long ago when the only thing mentioned in the financial news was the GFC – or global financial crisis. (Actually, as an aside, that period should be better described as the North Atlantic financial crisis because it started in the US and spread to the UK and Western Europe, with other countries less affected.)
- But now there is a new crisis dominating the airwaves and the epicentre is clearly in Europe.
- The GFC began when highly indebted home loan borrowers in the US ran into repayment difficulties when interest rates rose. More and more customers found that they couldn't keep up with repayments, causing bad loans to rise at banks. The fall-out spread to those who invested in the housing market in various forms, in turn causing banks to become very wary of dealing with other banks.

A sneeze turns into pneumonia?

- Just like a cold or flu, the financial jitters were highly contagious, affecting economies more broadly and dragging down sharemarkets across the globe.
- The European debt crisis is effectively a by-product of the GFC. During the GFC, countries tried to keep their economies growing by cutting taxes or spending more money. That wasn't a problem for countries with low debt levels like Australia. But it has certainly posed challenges for countries that started out with high budget deficits and debt levels.
- Investors have become more and more concerned that governments of countries like Greece, Portugal and Ireland might not be able to meet their debt repayments. As a result demand for these countries' government bonds have fallen, boosting borrowing costs (bond yields).
- European economies have attempted to help out their highly indebted neighbours by offering funds, but in return they have required these governments to meet certain conditions in getting their spending more in line with their revenue.
- Governments have responded by trying to cut their spending or increase taxes, but understandably the people in the affected countries haven't been overly supportive – to say the least.
- The worry is that countries could fail – effectively go broke – because they can't keep up with debt repayments. Others worry that countries like Greece will abandon the euro and return to the drachma.
- Just like the GFC, one of the biggest concerns is contagion. That is, a country like Greece doesn't pay its debts, causing its bankers to withdraw funds from other banks with the effect spreading through Europe and the world more generally.

Drivers of world economy - Contribution to growth 2011

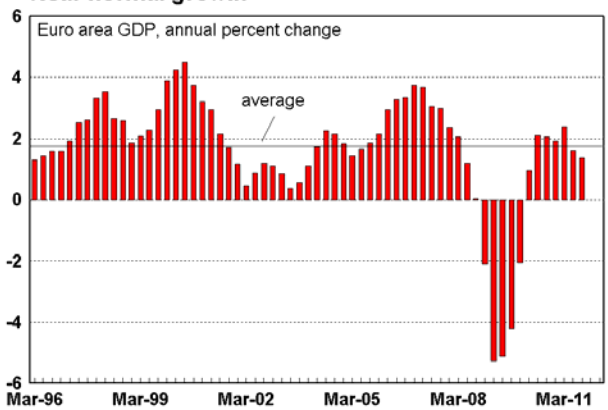
China	0.85%
United States	0.52%
India	0.18%
Newly Industrialised Asia*	0.15%
Germany	0.14%
ASEAN 5 #	0.14%
Brazil	0.13%
Russia	0.13%
France	0.08%
Canada	0.07%
United Kingdom	0.05%
Japan	-0.06%
Other countries	1.60%
World	**4.00%**

Source: IMF & CommSec
** Newly industrialised Asia – Hong Kong, Taiwan, Singapore and South Korea*
 # ASEAN 5 – Indonesia, Malaysia, Thailand, Philippines and Vietnam

Let's stick together

- Publicly, all European governments are committed to Europe staying together. But clearly the problems are significant and there are various ways the situation may be resolved, none of them overly palatable.
- At the end of the day countries need to show discipline in cutting some forms of spending, while at the same time focussing on ways to grow their economies – say, through building new roads, bridges, schools or hospitals.
- As any business knows, you need to keep the money coming in while at the same time controlling how much you spend. Austerity measures – where governments drastically cut spending in a short period of time– don't work without other measures to increase the money going to the government. Otherwise you just dig a bigger and bigger hole.

Near normal growth



Source: European Central Bank, CommSec

Investors need to be vigilant

- For investors these are clearly volatile times. If governments do the right thing and work through their problems, then confidence will return and sharemarkets will recover. But the longer that the problems continue and debt costs rise, then people will speculate about worst-case scenarios.
- It is important to remember that countries like Greece and Portugal are quite small – although Italy is a far different proposition – the eighth largest economy in the world. However, whether big or small, investors around the world want countries to meet their obligations.
- As we found out through the GFC, no matter how dark were the days, solutions were developed. What we don't know at present is what form those solutions will take and how long the recovery process will be. But clearly those sharemarket investors that took a longer-term view and bought in the dark days of the GFC have been rewarded.
- Aussie investors also shouldn't lose focus on the big picture. China continues to buy our iron ore, coal and other metals. Provided China continues to grow, so will the global economy and so will our economy here in Australia.
- As we found through the GFC if Europe or the US fell into recession again, China would cut interest rates and lift spending in order to keep its economy growing. And here in Australia the Reserve Bank would similarly cut interest rates to boost spending and building.
- For every risk, there is an opportunity and the current environment is no different.

WORLD 10yr Benchmark Rates

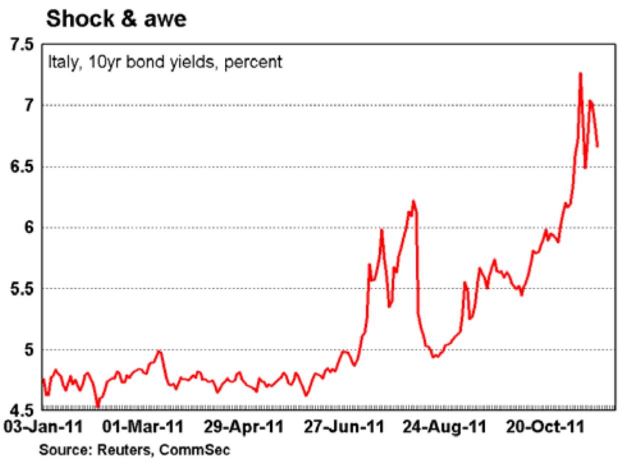
November 18 2011, percent

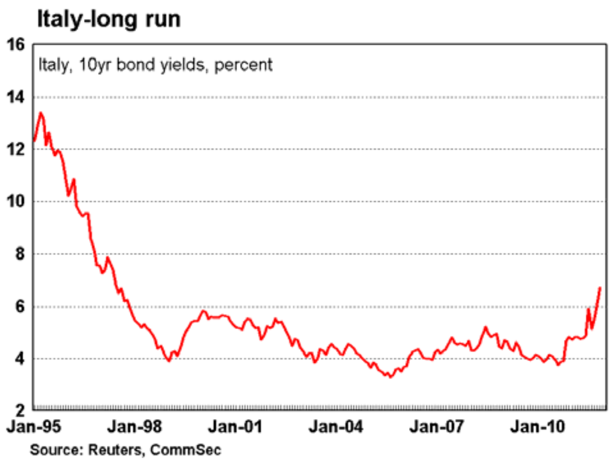
Greece	26.14	Slovenia	4.09
Egypt	15.50	Australia	4.07
Pakistan	12.20	Czech Republic	3.96
Vietnam	11.96	New Zealand	3.94
Turkey	9.97	South Korea	3.81
India	8.87	Malaysia	3.72
Russia	8.64	China	3.60
Hungary	8.45	France	3.48
Ireland	8.26	Thailand	3.41
South Africa	7.99	Austria	3.40
Romania	7.68	Finland	2.61
Croatia	7.03	Netherlands	2.53
Italy	6.72	Norway	2.53
Iceland	6.61	UK	2.24
Mexico	6.48	Canada	2.16
Spain	6.39	Denmark	2.06
Indonesia	6.33	US	2.00
Latvia	6.00	Estonia	1.96
Philippines	5.90	Germany	1.96
Poland	5.80	Sweden	1.75
Lithuania	5.75	Singapore	1.62
Bulgaria	5.20	Hong Kong	1.34
Belgium	4.86	Taiwan	1.33
Israel	4.61	Japan	0.95
Malta	4.33	Switzerland	0.89

Source: Reuters, CommSec

Why all the fuss about bond yields?

- One of the by-products of the European Debt Crisis is that there has never been so much written on government bonds. In the past the subject barely got a mention – being confined to a relatively small section of the financial markets or in university courses on finance. Now it seems that everyone is an expert on Italian bond yields.
- So what is a government bond? Well when governments spend more than they take in in taxes, they need to meet the shortfall. There are only so many things you can sell to raise the necessary funds, so the main way of meeting the shortfall is by borrowing.
- Similar to a company issuing shares to raise funds, governments issue bonds. The government hopes to entice investors by promising to pay back the funds in full at the end of the term or investment period. And in return for





the use of the funds, governments offer an attractive return (coupon).

- The interest rate or yield may be lower than you could get, say, on a term deposit, but the added attraction is that government bonds were considered the safest of investments. Companies or banks may fail, but on a government bond, you'll always get your money back in full – or so it was generally believed.
- Government bonds trade like shares on financial markets. And the usual principle applies – demand and supply. If demand for the bonds fall or supply rises, the price of the bonds fall. On bond markets, the actual yield or interest rate moves inversely to the price.

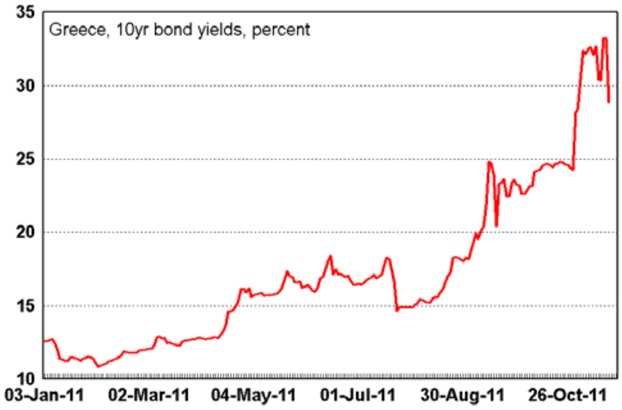
Not all countries are the same

- So if investors become worried that a certain government – say, Greece – may be more of a risk than a bond of another government – say, Germany – they may buy less Greek bonds and more German bonds. The Greek bonds may fall in price, pushing up the interest rate or yield.
- If for instance Greece now has to pay a return of 7 per cent on its bonds, rather than 5 per cent, then it will need to pay out more to its investors. In other words it pays the price for being in worse financial shape – bigger budget deficits and higher debts – than other countries.

The bad news doesn't stop there

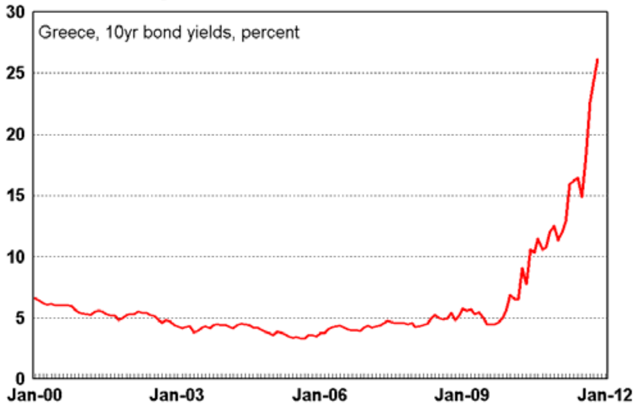
- So a country may be in worse financial shape and it pays the price by having to pay out more to investors on its debt, or bonds. The problem is that this can make already poor finances even worse.

Peaked?



Source: Reuters, CommSec

Greece-long run



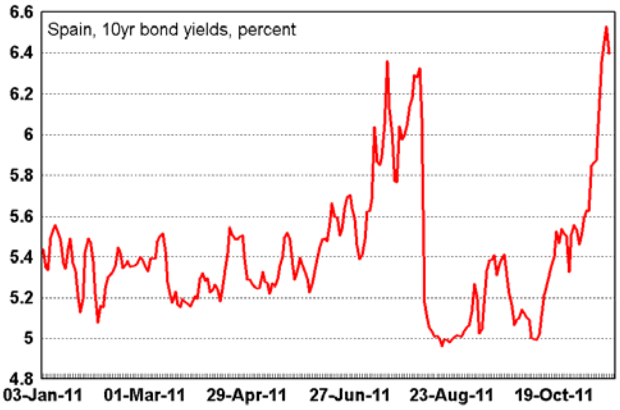
Source: Reuters, CommSec

- When government bond yields hit 7 per cent in Greece, Portugal and Ireland, the countries fretted that they wouldn't be able to find the money to pay investors as well as other obligations like old age pensions and salaries to public servants. As a result they sought "loans" or "bail-outs" from other European economies and the International Monetary Fund.
- Now the yields on Italian bonds have hit 7 per cent and investors are again worrying. Italy has around €350 billion of bonds that are reaching the end of their terms or maturities next year and they may have to pay roughly three times the interest rate that they paid last time round. Clearly that has the potential to cripple the country.

The solution

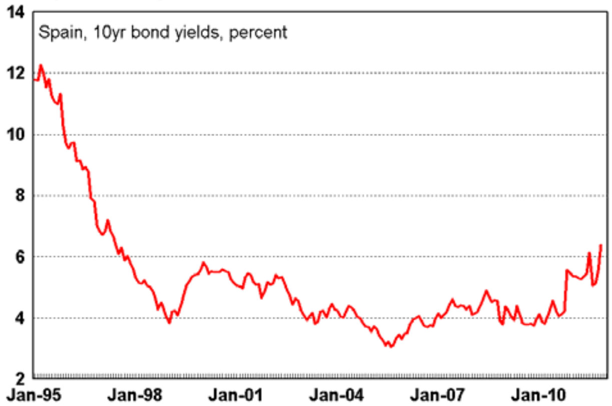
- The solution is quite simple. Investors need to have confidence that the Government is good for the money – that they will be able to pay back investors when the bond matures. If that is the case then demand for bonds rise, and if the supply of bonds doesn't change then the price of the bonds goes up, and thus the interest rate or yield

Volatile



Source: Reuters, CommSec

Spain - long run



Source: Reuters, CommSec

comes down.

- Alternatively, the Government needs to find investors that are willing to buy its bonds – a white knight if you like, like the European Central Bank. If the yield on the bonds is kept low, then this takes pressure off the government to meet the interest bill as well as its other bills.

So what does it mean for us 'down under?'

- If investors are worried whether they will get their money back on government bonds, then we could end up with a re-run of the global financial crisis (GFC) when banks didn't want to lend to other banks. As a result the cost of borrowing goes up. And as we saw in the GFC, if banks have to pay more for their money, we have to pay more as well – that is, it tends to get passed on to home loan and business borrowers.
- And as we also saw in the GFC if banks aren't lending and money is harder to get, investors get worried that less borrowing will lead to less spending and therefore slower growing economies. As a result, sharemarkets fall on fears about weaker economies as well as investor jitters.
- Clearly, it's in everyone's interests for the highly indebted countries of the world – especially Europe – to make attempts to reduce their debts to manageable levels and thus gain the confidence of investors.

Craig James, Chief Economist, CommSec
Work: (02) 9118 1806; Home: (02) 9525 2739; Mobile: 0419 695 082; Twitter: @craigjamesOZ