

Commentary

Has Europe Finally Rescued Itself? Probably Not.

By: SEI Investment Management Unit

- Although critical details are still being worked out, the European Union's (EU) recently announced rescue package for Greece is the broadest, most strategic attempt yet to deal with Europe's sovereign debt crisis.
 - The plan aims to lower Greece's government debt-to-gross-domestic-product ratio over the next decade while containing potential short-term damage to the financial system, increasing the size of the European Financial Stability Fund (EFSF), and garnering support from private-sector investors and foreign governments.
 - Greece, which must agree to the plan before it can be implemented, is experiencing serious political upheaval. It must first form an interim unity government and name a new prime minister before the proposed rescue plan can be voted on.
 - Under the most optimistic outcome, the plan buys Greece, troubled European governments, and the European and global financial system some more time, kicking the can further down the road to be fully dealt with at a later date. A more pessimistic view is that Greece and its creditors will experience a disorderly debt collapse, and Greece will be forced to exit the European Monetary Union (EMU or eurozone, the countries that have adopted the euro as their official currency).
 - Whatever the outcome, bringing additional clarity to the issue is likely to benefit financial markets and investors far more than the prevailing confusion and uncertainty.
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An Uncertain Future

Hammered out during yet another contentious EU summit (there have been more than a dozen over the last 21 months), the recently announced rescue plan for Greece is the most ambitious attempt yet to deal with the eurozone's ongoing government debt challenges. The plan's primary objective is to lower Greece's gross government debt-to-GDP ratio from 160% to 120% by the year 2020.

Although markets reacted favourably to the announcement of an agreement, Europe once again demonstrated its propensity to snatch defeat from the jaws of even a minor victory, as Greek Prime Minister George Papandreou promptly called for a confidence vote (the second one since July of this year) on his ruling Socialist Party government and a country-wide referendum on the bailout. These unexpected actions were a result of increasingly hostile public protests in opposition to the austerity measures attached to the ongoing series of bailout funds from the EU and IMF and purchases of Greek government debt by the European Central Bank (ECB).

Papandreou's government, which did not survive the confidence vote that took place on Friday, November 4, withdrew the referendum following stern rebukes from fellow EMU leaders. The current plan for Greece is to name a new prime minister, form and install an interim government, and subject the bailout proposal to the Greek Parliament for approval. If it is approved, Greece would receive the next tranche of bailout funds in mid-December of this year, and early elections would potentially be held by mid-February 2012.

Assuming all of this unfolds according to plan (which is not a sure bet), the Greek government will still struggle to service its remaining debt burden. And even under the best of circumstances, we remain sceptical of some of the underlying assumptions behind the rescue plan, such as continuing structural reforms, healthy economic growth and the political will to endure long-term fiscal consolidation.

To work, the bailout plan requires holders of Greek government debt (other than public institutions such as the European Central Bank) to incur a haircut of 50% (or approximately €100 billion) on those holdings. The plan seeks to prevent the financial carnage this might otherwise cause by construing the write-downs as voluntary in order to avoid triggering default clauses in various financial instruments and contracts. It encourages private investors and foreign governments to help re-capitalize affected EU banks, while giving the banks until mid-2012 to meet stricter capital requirements. The plan also enhances the firepower of the recently established EFSF, tentatively authorizing it to raise up to €1 trillion (\$1.4 trillion) of capital, up from an earlier limit of €440 billion (its currently available capital is estimated at €250 billion).

While European policymakers are desperate to avoid having the plan characterized publicly as a default by the Greek government, it clearly is (as noted in previous SEI commentaries, this outcome was all but assured). Under the terms of the latest bailout, Greece will have effectively defaulted on half the nominal value of its debt, and even more when all of the originally promised cash flows are taken into consideration. In our view, the write-down of Greek debt, whether officially voluntary or not, constitutes a default by any reasonable standard.

Assuming the proposal is approved by the Greek Parliament, details regarding implementation of the measures must still be finalized in the weeks and months ahead, so the risk of negative surprises, although much lower, remains on the table.

Bigger Cans to Kick

While equity markets reacted positively to the initial news of an agreement, they pulled back in the following days—first as the many unanswered questions about the bailout came to light, and later as the ruling Greek government imploded.

One particularly unsettling aspect is that the EU's post-debt-crisis statement focused almost entirely on the solvency and capitalization of the banking system (a symptom) without explicitly addressing the scope of the eurozone's government debt problem (the cause) or the uncompetitive cost structures harming the economies of the biggest debtor countries. EU leaders may feel that addressing problems in Greece is a victory, but what happens if other fiscally-challenged governments—Ireland, Italy, Portugal and Spain—have similar trouble servicing their debt? According to the International Monetary Fund (IMF), Greece's estimated net government debt in 2010 was only 10% of the total for Portugal, Ireland, Italy, Greece and Spain, as Exhibit 1 shows.

Exhibit 1: Eurozone Net Government Debt (Euros, Billions)

Country	2005	2010	2015 (Predicted)
Austria	127	170	231
Belgium	249	322	426
France	978	1,456	1,840
Germany	1,190	1,483	1,829
Greece	164	259	293*
Ireland	26	86	139
Italy	1,275	1,542	1,809
Netherlands	183	270	410
Portugal	89	135	179
Spain	315	569	888
Total**	4,596	6,291	8,045

Source: IMF, SEI

* Not adjusted for current rescue package.

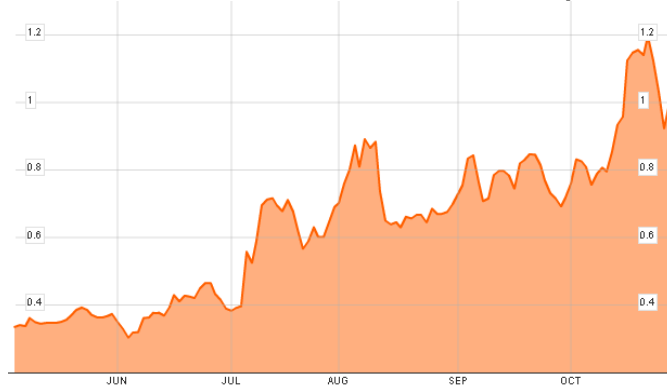
** Total excludes Cyprus, Finland, Luxembourg, Malta, Slovak Republic and Slovenia.

Italy and Spain are sizeable economies, and the Italian government is the world's fourth-largest issuer of sovereign debt behind the U.S., Japan and Germany. So while the newest EU rescue package may be the most comprehensive plan to date, it's important to ask whether it's large enough to deal with problems in Ireland, Italy, Portugal and Spain (and possibly Belgium and France). It took considerable effort to convince the private sector to agree to a voluntary reduction of €100 billion in the principal value of their holdings. If a 50% haircut is enough (at least at the moment) to address the sustainability of Greek debt, what will it take to do the same for the others?

These questions are all the more pressing given the selling pressure that French government debt has recently come under (Exhibit 2) and the fact that the total eurozone government debt burden is expected to rise in the coming years, as shown in Exhibit 3.

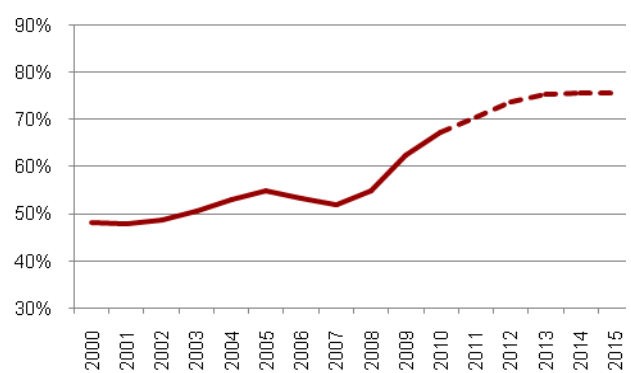
Whatever the final numbers, it is very likely in our view that further rounds of negotiation and additional write-offs will be required. Despite the recent success negotiating concessions from private-sector creditors, and current plans to expand the EFSF, the sovereign debt crisis will continue to pose a massive challenge to Europe.

Exhibit 2: French 10-Year Government Spread



Source: Bloomberg
Spread is the difference between the yield on 10-year French government and 10-year German government securities. A higher spread indicates that investors perceive greater risk in French government debt.

Exhibit 3: EMU Government Debt-to-GDP



Source: IMF, SEI
Net government debt to GDP of Austria, Belgium, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal

Will Crisis Containment Foster Economic Growth?

While European leaders may have ring-fenced the eurozone government debt crisis for the time being, the agreement does little to support or foster stronger aggregate demand. It appears from the latest bailout proposal that EU policymakers are determined to force private-sector creditors to share in the pain being inflicted on debtor countries while striving to contain any associated financial fallout. They may well succeed in that, but neither public-sector austerity nor private-sector haircuts are widely viewed as pro-growth policy measures. The

increased capital requirements for banks could force lenders to cut lending, possibly leading to a credit crunch in a replay of 2008. Some of the structural reforms being demanded of Greece and other countries may clear the way for healthier long-term growth, but little is being done within Europe to foster stronger growth in the near-to-intermediate term.

This perspective is especially relevant to Italy. While the Italian government is a major sovereign debt issuer, the country's private sector is relatively thrifty. As a result, its overall external financial position, as shown in Exhibit 4, looks relatively unhealthy.

Exhibit 4: External Government and Private Sector Debt, U.S. Dollars

Country	External Debt Per Capita	Year
Italy	36,841	2010
Portugal	46,795	2010
Spain	47,069	2010
Netherlands	47,172	2009
United States	47,568	2011
Greece	47,636	2010
Germany	57,755	2010
France	74,619	2010
Belgium	113,603	2010
United Kingdom	144,338	2010

Source: World Bank, CIA, IMF

External debt is the total debt owed by public sector (government) and private sector (households, corporations) borrowers to non-residents.

However, the primary concern impacting Italian government debt is the outlook for the country's economy, which will be hindered for the foreseeable future by relatively low productivity growth and an aging population. As a general rule of thumb, as long as the rate of interest paid by the government does not exceed the growth rate of the domestic economy for a significant period of time, the government should have little trouble servicing its debt. Conversely, when the rate of interest demanded by the market significantly exceeds the rate of economic growth, then a debt crisis is likely to ensue. Some observers fear that Italy could eventually face the latter situation (a fear that current yields on Italian government debt and growth expectations for the Italian economy appear to justify).

For now, European leaders have come up with a framework for containing the damage that has resulted from this experience with Greece. But they have done little to foster more robust growth throughout the eurozone, and thus little to eliminate the risk of additional credit market and financial upheaval beyond the short to intermediate term. The current framework simply does not appear large enough to manage the potential problems that will arise if the European economy grows more slowly than required by its fiscally challenged governments.

What Role for the ECB?

It is interesting to note that the ECB, which has played a critical role at times by buying troubled government securities on the open market, was barely mentioned in the EU's post-summit statement. (What references were made pertained only to banks' funding and liquidity.) We continue to believe that the longer the sovereign debt crisis wears on—and especially if the current rescue package and pace of future growth prove incapable of resolving it—the more likely it is that the ECB will be called on

as the ultimate backstop to the eurozone's fiscal troubles.

Such an outcome could eventually lead to a more conventional policy-making arrangement within the eurozone. Typically, it falls upon a central bank to prevent or contain financial risks, and to maintain a policy stance appropriate to business conditions and thereby manage inflation expectations. When business and employment conditions are particularly or stubbornly negative, fiscal, regulatory and other policy levers can be directed at stimulating economic growth. However, Europe is not presently organized in a way that allows for this approach; EMU nations share a central bank, but no central fiscal authority to manage eurozone-wide revenues and expenditures at a supranational level. As a result, constructive and well-coordinated measures require plenty of time and negotiation among EU members, as the many summits related to the debt crisis demonstrate.

If Europe's sovereign troubles continue to intensify, member nations will eventually have to choose between some form of tighter economic integration and full or partial dissolution of the EMU. For example, Germany, traditionally a net exporter, has been very well served by the single-currency union, as the governments of its European export markets are no longer able to devalue their currencies. The challenge is that this arrangement has created an unstable economic dynamic that will be difficult to solve without closer fiscal integration of the EMU. Germany's economic interest in maintaining this arrangement may serve to influence the eurozone toward closer fiscal integration over time—but it will require a change in the state of mind of most German taxpayers, and perhaps a change in how the ECB's role and functions are viewed within the eurozone.

Our View

The EU agreement brought risk-seeking back into the market in a big way for a short time, but we expect that headline and macro risks will continue to buffet financial markets. The Organisation for Economic Cooperation and Development recently forecast that “advanced economies are looking at two years of weak growth and high unemployment and the outlook is likely to worsen unless Europe reins in its sovereign-debt crisis.” We are not in the

camp of those calling for global recession, but we do not expect the world economy to do much more than continue to muddle along for the foreseeable future. While certain risky asset classes continue to carry attractive long-term price tags in our view, investor fear and risk aversion remain elevated, even after the recent equity rally. For the foreseeable future, the fate of world financial markets will continue to hinge in large part on the direction of Europe’s debt crisis, financial system and economy.

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