



Investment Briefing

Europe gets serious, sort of.

28 October, 2011

Brian Parker CFA
Investment Strategist

Yesterday, the leaders of the Euro zone economies announced a package of measures designed to restructure Greece's public debt, and recapitalise Europe's banks that are set to take a 'voluntary' haircut on their holdings of Greek debt.

The announcement has **three broad components**. First, negotiations with private sector lenders have resulted in those lenders agreeing to a voluntary 50% haircut on their Greek debt holdings, a move which reduces Greece's public debt to GDP ratio from 160% of GDP to 120%.

Second, Europe's banks are required to achieve a level of tier 1 capital equivalent to 9% of risk-weighted assets by June 2012 which, according to estimates released by the European Banking Authority, requires major banks in 13 countries to raise EUR106.4bn of additional capital, including EUR30bn in Greece, EUR26bn in Spain, EUR14.7bn in Italy and EUR8.8bn in France. That capital is to be obtained from the private sector wherever possible – where not possible, then national governments are meant to cough up, and where that is not possible, the European Financial Stability Facility ("EFSF") can be utilised.

Finally, the remaining funds in the EFSF (after providing a second aid package to Greece of about EUR100bn) will be leveraged by 4 to 5 times so that its total firepower will be EUR1 trillion. The details of how this will be done (for example, via first loss guarantees on new debt, a Special Purpose Vehicle or some combination of the two) are to be determined by the end of November.

Markets have responded to the package extremely positively. Share prices have soared in the last 24 hours. How much of this reaction is really justified? Sadly, not very much. If we look at the announcement, it seems that Europe's leaders have produced the very barest minimum required at this point, and perhaps markets were simply relieved that they achieved even that! I hate to sound like a party pooper, but...

A 50% haircut that takes Greece's debt to GDP ratio back to 120% is not enough. The austerity that is still required by the Greeks is just not achievable. Even with a primary budget balance or small surplus (ie the Greek Government raises enough tax revenue to fund its day to day operations – quite novel really) which would still require a significant degree of austerity, the debt interest alone would still leave an overall budget deficit of around 8% of GDP.

The lack of detail around the leveraging of the EFSF is puzzling given how long they have had to think about this, and suggests that there are real tensions about how to achieve this and



MLC Investment Management

who is going to fund it, not to mention the problem of financially stretched Governments stretching themselves even further, to bail out players that are even more stretched.

Recapitalising Europe's banks is essential, but EUR 106 billion simply is not enough if you assume that this problem is about much more than Greece. A haircut for Greek bondholders is a start, but what about Ireland and Portugal – not to mention Spain and Italy? Depending on the assumptions you make about likely Portuguese and Irish haircuts, coming up with a figure of EUR300 – 400 billion is pretty easy.

European economies remain extremely fragile. Austerity programs are making economic conditions worse, which in turn worsens public finances, which then presumably requires even more austerity, and so on. This is bordering on madness. Moreover, getting banks to recapitalise without Government funds helping out is highly likely to further restrict the supply of credit in Europe, which harms the economy and in turn, public finances.

Let's be fair, it's a start, but as EU Commission President Jose Manuel Barroso indicated yesterday, this is a marathon, not a sprint. For the time being, financial markets seem willing to again give Europe the benefit of the doubt, but for how long?

Important Information:

Any advice in this communication has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on any advice in this communication, consider whether it is appropriate to your objectives, financial situation and needs. You should obtain a Product Disclosure Statement or other disclosure document relating to any financial product issued by MLC Investments Limited ABN 30 002 641 661 and MLC Nominees ABN 93 002 814 959 and consider it before making any decision about whether to acquire or continue to hold the product. A copy of the Product Disclosure Statement or other disclosure document is available upon request by phoning the MLC call centre on 132 652 or on our website at www.mlc.com.au

An investment in any product offered by a member company of the National group does not represent a deposit with or a liability of the National Australia Bank Limited ABN 12 004 044 937 or other member company of the National Australia Bank group of companies and is subject to investment risk including possible delays in repayment and loss or income and capital invested. None of the National Australia Bank Limited, MLC Limited, MLC Investments Limited or other member company in the National Australia Bank group of companies guarantees the capital value, payment of income or performance of any financial product referred to in this publication.