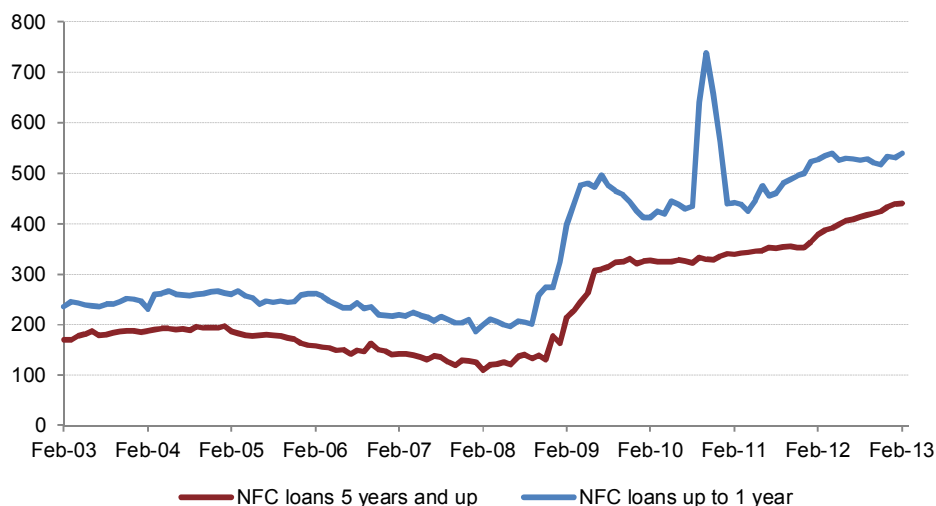


If the EA abandons austerity

- **Austerity is already being abandoned in parts of the euro area**
- **Germany may have to accept it to maintain its leadership**
- **Good news for risk assets – but it will only last if it also brings sustained stronger growth**

As was widely expected, the ECB cut its repo rate by ¼% today. However, 25 basis points less on the ECB repo rate is unlikely to do much, not least since market interest rates are already lower. Nor are broad money and credit growth likely to accelerate much at a time when the monetary and regulatory authorities are continuing to stress the need for banks to raise their capital. Meanwhile, the ECB is still wrestling with a more important problem for the EA, the *de facto* fragmentation of money markets, leading to substantial differences in borrowing rates by country.

Spreads between highest and lowest national bank lending rate for loans to NFCs by duration

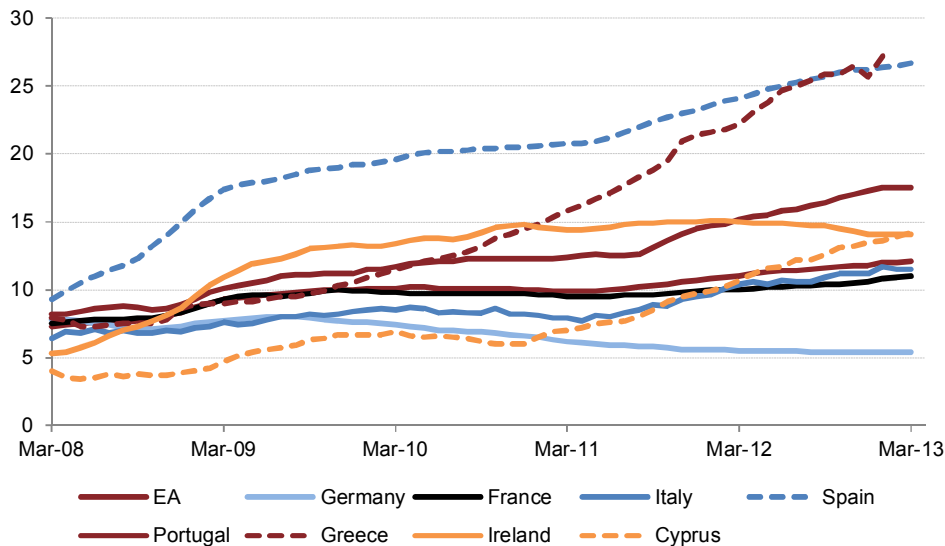


Recent EA data has been almost unanimously weak. Economic sentiment dropped in both March and April (as did the German Ifo index), broad money and credit growth remain weak and in spite of austerity policies, public sector debt continues to rise, at least in the periphery. From a political perspective, a greater concern may be the continued rise in unemployment (including in Germany), with the rate reaching ever new records. The overall EA unemployment rate is bad enough at 12.1%; however, Spain at 26.7%, Greece also near 30% (latest data is from January, when the unemployment rate was 27.2%, since which is it unlikely to have improved) and Portugal at 17.5% are considerably worse.

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Unemployment rates, EA and by country



Perhaps unsurprisingly, there is a strong likelihood of a sea-change in euro area policy. The French government has never bothered to hide its dislike of German-induced austerity and has postponed reaching its 3% budget deficit target until 2014. It would be happy to postpone it further. The ruling Socialists Party fulminates against the German Chancellor's 'selfish intransigence' (and the German Economics Ministry retaliates by warning that the 'proud neighbour' France risks turning into the 'sick man of Europe'). The new Italian Prime Minister has already abandoned tax increases worth €6bn; and the Spanish government has once again widened its budget deficit target for 2013 and has also postponed reaching a 3% budget deficit until 2016 (two years later than originally planned). Even the Slovaks, hitherto on the harsh side, are demanding an end to the austerity drive (admittedly with a new government).

Any let-up of current policies would likely face substantial opposition from Germany and perhaps also from some of the other creditor countries. This does not mean that it cannot happen; but it does mean that it is unlikely to receive German official approval until after the German federal election in September. A more complete easing of austerity – notably in Germany, which is the key country in more ways than one and which has the space to ease, will therefore have to wait until the end of the third quarter.

A change of policy may still not be welcomed by German politicians (although this may depend on the composition of the post-election government). However, some countries – notably France, Italy and Spain, who are not bound by any bail-out terms and who combined make up half EA GDP – can of course implement some easing on their own and have as noted above, already begun to do so. From a

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German perspective, it may therefore become preferable to accept an inevitable policy change, rather than oppose it and see it happen anyway with a consequent erosion of German influence.

Easing austerity can take many forms. However, what they all have in common is that budget deficit targets will be eased and postponed; that public spending is likely to rise and that tax increases will be abandoned or postponed. More importantly, what is the likely impact, on output growth as well as on financial markets?

On growth, a simulation by Oxford Economics (OE) estimates that halving the currently planned austerity measures (as measured by the IMF's structural budget balance forecasts) would raise the level of EA GDP relative to the OE baseline by 0.2% in 2013 and by a further 0.7% in 2014, mainly on stronger household consumption and corporate investment.¹ The strongest country impacts would (unsurprisingly) be in Greece and Spain (GDP levels 0.5% and 2.3% higher and 0.8% and 2.5% higher respectively), but the impact on France and Italy would also be significant. While welcome, this would not be enough to avoid a likely contraction in EA GDP in 2013. Moreover, this assumes that the confidence-boosting impact of the policy change announcements will actually translate into stronger activity. There is a danger that any easing of austerity now will be perceived to be a postponement of even harsher measures – notably so if governments do not make use of the pause to lay out credible deficit reduction plans but simply boost spending. If so, households and companies may not increase their spending as hoped.

A crucial role will also be played by bond market reaction. If the view is that a policy change will be successful, bond yields will remain unchanged or fall further, notably in the periphery. That could lead to a virtuous circle, not least since rising nominal GDP should have some beneficial impact on debt/GDP ratios. If, by contrast, bond markets remain unconvinced of a new policy's success, or if the initial boost to activity is not sustained, less austerity with little or no effect barring deteriorating budget balances is likely to push periphery bond yields higher and lead to a renewed flow of capital to the safety of the core.

With regards to risk assets, some of the impact of the less austerity is already being seen in rising equity prices. However, a formal German acceptance of a new policy is likely to prompt a further jump, similar to the 'QE announcement effect'. Yet here too the key issue is not so much whether austerity is eased, as whether less austerity really does bring about sustained stronger growth. If it does, share prices should rise further. Combined with a stronger outlook for the United States – which will also benefit from increased activity in the Eurozone, as will the UK – this could lead to a global share price rally well into 2014.

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¹ Please note that since 15th April I am a Special Advisor to Oxford Economics.

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