Assante™ WEALTH MANAGEMENT

The BIG Picture

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A glass half full

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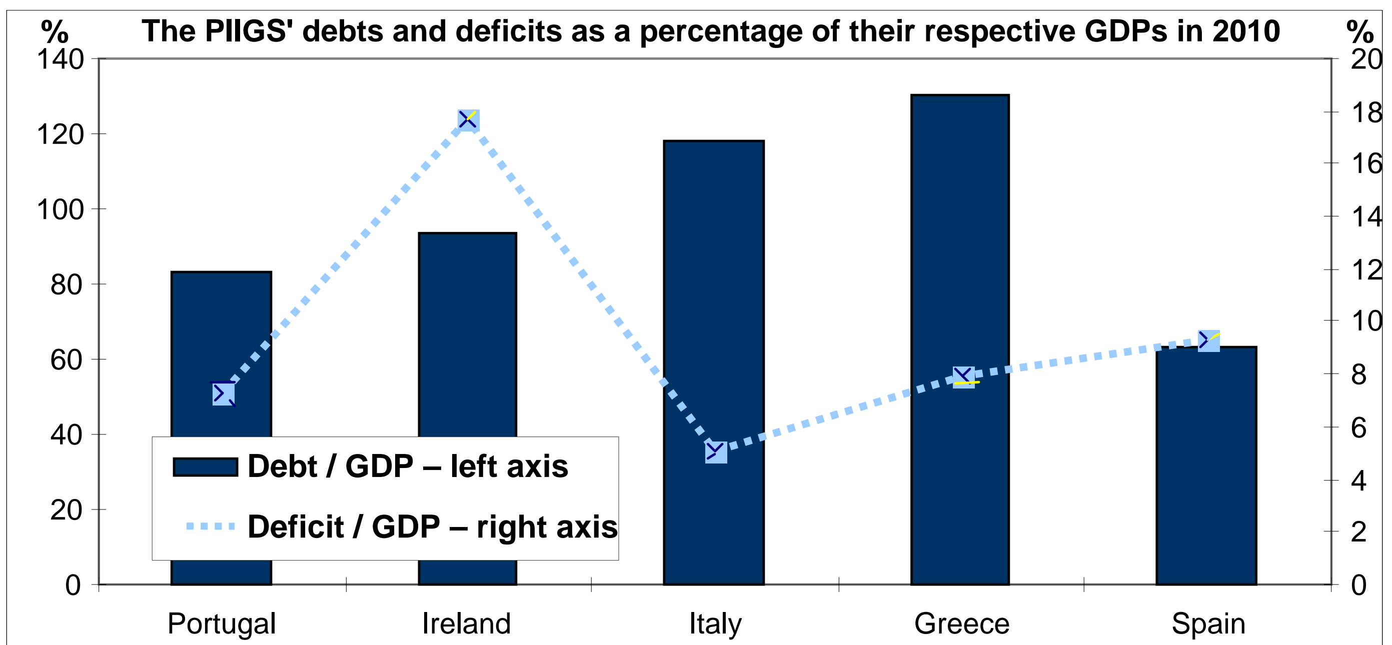
Recent European history seems to be full of financial crises. In the fall of 2008, Iceland’s three major commercial banks collapsed, and that was followed by more turmoil on the continent. However, even though Europe has seen plenty of shocks, signs of improvement have appeared. As with most industrialized nations, the major European economies have found that global growth, driven by the developing world, has translated into stronger exports. In addition, the region-leading German economy has seen considerable improvement since the end of the recession.

Debt and deficit

Most of the headline-grabbing news in Europe has been with respect to what is now being called the “sovereign debt crisis.” As the original creation of the Eurozone raised the interconnectivity of those countries that use the euro, so too did it increase the risk of contagion spreading if financial problems were to emerge. Greece’s borrowing problems became a headline issue in early 2010. Worries quickly spread to include nations that would eventually be branded the “PIIGS” – Portugal, Ireland, Italy, Greece and Spain. After the introduction of the euro in Greece in 2001, the country was able to borrow at lower interest rates than had previously been possible under the nation’s former currency, the drachma. However, new borrowing at lower interest rates was not used to retire higher interest rate debt: Greece’s overall indebtedness continued to climb, along with heavy social spending.



Source: International Monetary Fund

As can be seen in the chart on the previous page, debts and deficits among the so-called PIIGS were significant economic issues in 2010. The global financial crisis that began in 2008 and the subsequent widespread recession had a particularly large effect on Greece. Real gross domestic product (GDP) declined by 2.0% in 2009 and the International Monetary Fund expects the Greek economy will have contracted by an additional 4.0% during 2010. Eventually, government austerity measures and a European Union loan arrangement helped to restore some stability to the Greek government's finances. Similarly, Ireland was on the receiving end of a €67.5 billion bailout later in 2010. As worries over the plight of Portugal arose in the wake of the Irish crisis, a framework for assisting member nations emerged. To shore up longer-term confidence in the euro, European Union finance ministers also agreed on a permanent mechanism that from 2013 onward would allow a country to restructure its debts once it has been deemed insolvent.

Currency implications

Interestingly, if the PIIGS were applying today to enter the Eurozone and use the euro as their common currency, they would not meet the Maastricht criteria, which are the requirements for membership:

1. **The ratio of government deficit to GDP must not exceed 3% and the ratio of government debt to GDP must not exceed 60%.**
2. **There must be a sustainable degree of price stability and an average inflation rate, observed over a period of one year before the examination, which does not exceed by more than one and a half percentage points that of the three best performing member states in terms of price stability.**
3. **There must be a long-term nominal interest rate which does not exceed by more than two percentage points that of the three best performing member states in terms of price stability.**
4. **The normal fluctuation margins provided for by the exchange-rate mechanism must be respected without severe tensions for at least the last two years before the examination.**

Source: European Central Bank

However, today's practical realities of maintaining the Eurozone have allowed for flexibility. Debt and deficit *targets* as opposed to unbending *requirements* have become part of the bailout packages. As well, because these nations are members of the Eurozone, they cannot unilaterally stimulate their respective economies with monetary policy. They are not free to independently pursue policies like lowering interest rates or using quantitative easing if they desire – options that are available to nations like Canada and the U.S., for example, which do not have linked currencies. Eurozone countries face the catch-22 of wanting to stimulate their economies but having to adopt austerity measures to qualify for the bailout packages.

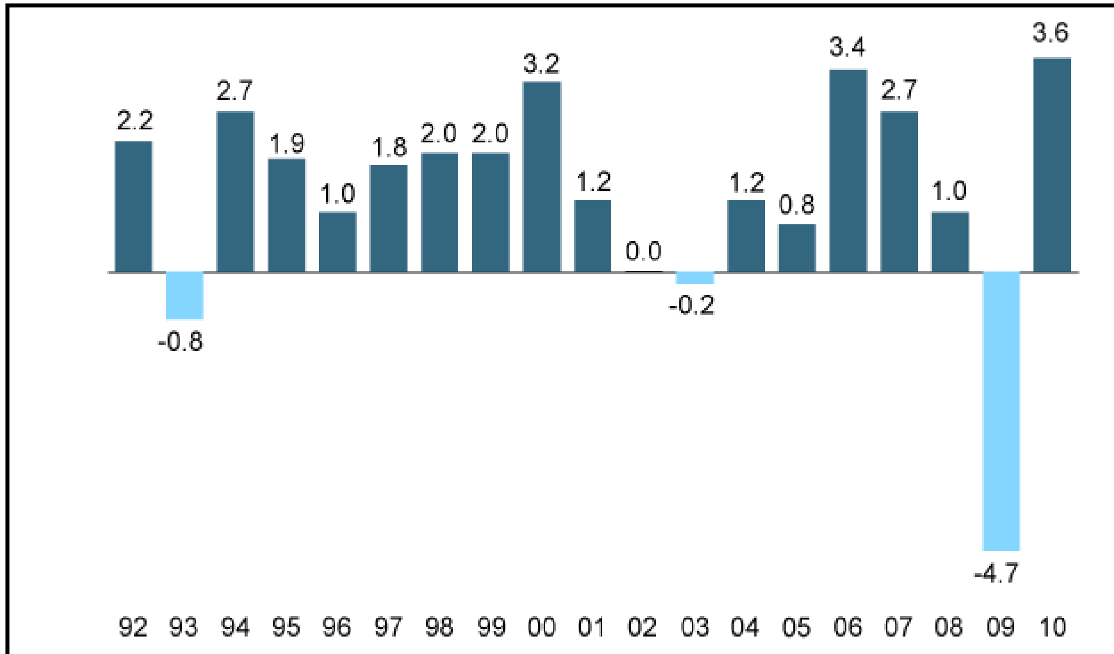
Germany generates robust growth

While much recent market attention has been focused on the travails of the PIIGS, significant improvements have been seen in Europe, particularly in Germany. By the close of 2010, Germany recorded a new 18-year low in unemployment, declining to 6.8% – and its employment level exceeded the pre-recession peak. In line with the employment gains, wages and salaries rose 3.8% during 2010. However, consumption edged up only 0.5% over the year.

Source: Statistisches Bundesamt, Wiesbaden 2011

Despite the relatively soft growth in Germany's domestic spending, the economy recovered surprisingly quickly from the economic crisis, revealing some disparity between it and other European nations. German gross domestic product (GDP) advanced at roughly twice the pace of the Eurozone economy as a whole for 2010. In fact, Germany's overall economy grew at its strongest rate since the country's reunification in 1990, as can be seen in the chart on the next page. Significantly, trade was key to the nation's improving circumstances. Exports in 2010 surged 14.2% in inflation-adjusted terms, while imports rose 13.0%. This followed on the heels of declines of 14.3% and 9.4%, respectively, in 2009. Not surprisingly, developing nations where economic growth has been strongest were providing growing demand for German exports. In particular, well-recognized luxury brands experienced strong export growth. Chinese demand for luxury autos has been especially robust. According to marketing research firm J.D. Power and Associates, China's luxury car segment expanded by more than 40% in 2010 and nine of the top-selling luxury models in China are German, led by Audi.

German GDP
Change on previous year as a percentage



Source: Statistisches Bundesamt, Wiesbaden 2011

Elsewhere

While China is not the only destination for European exports, it does stand out as one of the fastest growing. Global management consulting firm Bain & Company estimated that the Chinese luxury market grew by more than 23% in 2010. As this suggests, one of the paradoxes of this communist country is that luxury exports from Europe are in very high demand. Italy's Ferrari announced its 999th Chinese customer in January 2010, something that would have been impossible before China began its economic reformation. Also, retail outlets for other well-known European luxury goods providers, from clothing to jewelry, are becoming more commonplace within the country. The United Kingdom, France and the other nations that export these goods will derive increasing benefit from this trend. Avoiding protectionism and fostering improved trade ties should eventually benefit all of Europe.

Conclusions

- The European sovereign debt issue will continue to take time to play out. Additional bailout funds and austerity measures may yet be required, but in the end the fiscal and monetary lessons learned will provide a firmer base for the region's economic expansion.
- Germany stands as an example of how good economic and financial market news can be drowned out by other events within the region. Good prospects for continued expansion in trade will further bolster overall economic growth for Europe.
- Looking beyond the headlines for investment opportunities can bear fruit.
- Investors can capture opportunities if they use a disciplined approach, professional advice and well-diversified portfolios.

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