Europe Update 12 December 2011

Pre-emptive rate cut.

Last week, the Reserve Bank of Australia (RBA) decided to take out more insurance against the risk of Europe getting out of hand, by reducing the cash rate by a further 25 basis points to 4.25%.

This makes sense, given the lags involved with monetary policy. No doubt, global growth will start 2012 off in a shaky fashion but the profile for growth should improve over the year as economies respond to government and central bank stimulus.

Does the fact that the RBA have eased twice already signal that we are in a major easing cycle? Many believe that one further cut is likely in February and that should hopefully be enough to provide the non-resources sector with enough of a buffer to weather any adverse offshore developments.

I apologise, in advance, for the heavy use of acronyms (unavoidable I'm afraid)….

Developments in Europe over 8 and 9 December have left us with a new "fiscal compact", a proposal for an additional €200 billion to be made available to the International Monetary Fund (IMF) and an agreement to bring forward the start date for the 'European Stability Mechanism' (ESM) from July 2013 to July 2012. The response from the European Central Bank (ECB) has been muted on the issue of supporting sovereign debt, but they did cut their cash rate and announce a strong package to support liquidity in the financial sector.

The sum of these measures is no panacea to current problems and while implementation risks abound, **progress** was made.

Tiring of 'Eurogeddon'.

I'm not a raging optimist but to me this feels a lot like the end of February 2009, where we seemed to be at a point of total pessimism - from there, the market bounced 44% over the next eight months. So, while five governments have recently fallen across Europe (Italy, Greece, Spain, Ireland and Portugal) and Germany could only sell two thirds of its own bond auction, you can be excused for being in the 'Eurogeddon' camp.

However, just like the US three years ago after the collapse of Lehman Brothers, Europe is now ready to act (in its dithering committee way) post its own Lehman experience (Greece). So, amidst all the Euro negativity I thought it would be different to raise some positive points about the common currency.

5 reasons to like the Euro (compared to 17 currencies):

1. A common currency across 17 nations allows greater price transparency and lower transaction costs than 17 separate currencies.

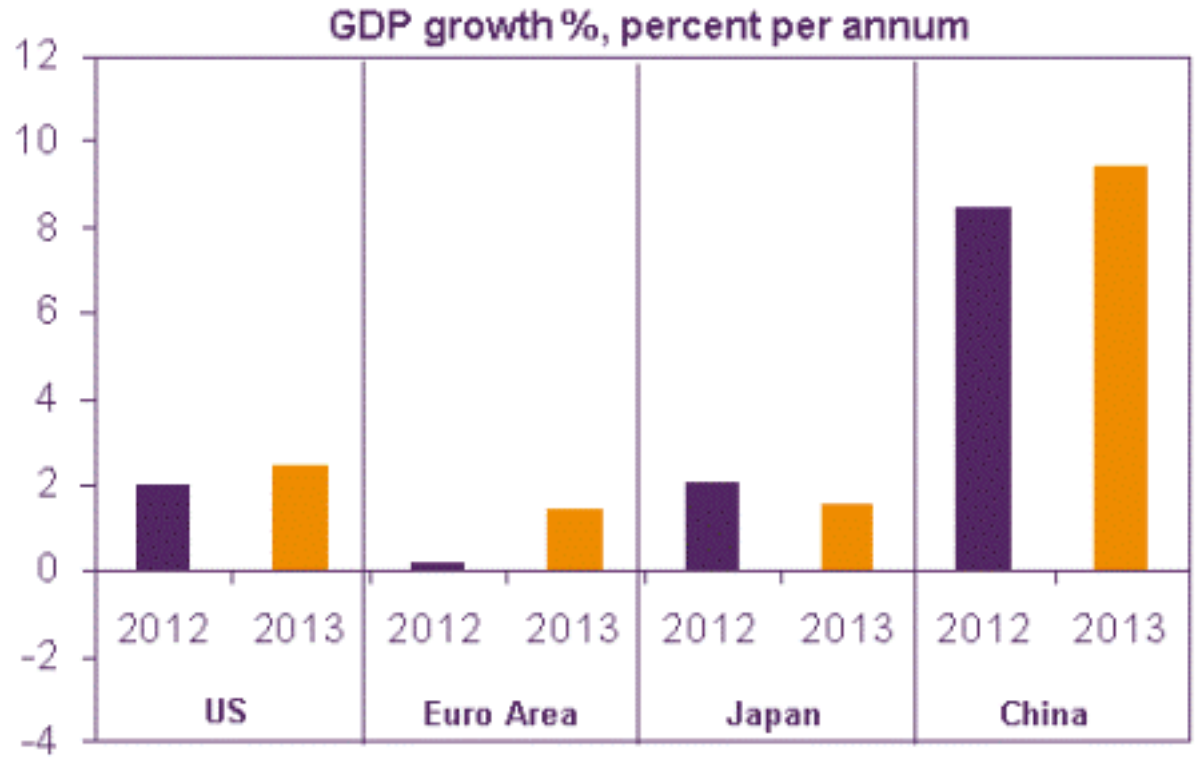
2. Cross border trade and movement of workers is enhanced (although cultural/language differences are still big factors).

3. The Euro relies on minimum standards (sure some have been slack, or in Greece's case very slack, but this is similar to many struggling American states eg California).

4. We're seeing important, positive steps from key players in the Eurozone 'debt-trap' with countries like Ireland showing they can make progress with structural reform, Italy proposing to introduce a €30 billion package of new taxes and spending cuts and the Greek parliament overwhelming approving next year's austerity budget (including more unpopular austerity measures).

5. ... and currently, its gross debt/GDP ratio of 89% is less than the US or Japan.

The following scenarios of expected growth in Europe, US, Japan and China are interesting. While they predict a mild recession in Europe, the outcome of the other countries is reasonably positive.



Source: OECD.

My view is that the political will is now there to ensure that we, eventually, get enough firepower through the European Financial Stability Facility (EFSF), IMF etc to quell markets and move towards a longer-term solution.

The resolve of many.

As reported on the weekend, the UK and three other countries now stand outside the tougher new resolutions of the bulk of countries in the euro area. Much of the attention has been focused on David Cameron's decision, with mixed reactions and predicted outcomes for the UK ranging from great, awful and everything in between. While it's far too early to predict the long-term outcome for the UK, in the short term, as we've seen on the news across the weekend, it's meant isolation from the other euro leaders and some strongly worded comments about "lousy compromises".

What does the new treaty mean? While the initial signs are muted, my optimism about the Euro remains intact (at this point). In order to steady fears and restore sentiment to a level where markets and investors are responding to fundamentals, we needed realistic measures and political resolve to improve the economic stability and governance of the region. While we now seem to have moved a little closer to this, there is still a long way to go to resolve the sovereign debt issues for Greece, Italy etc.

Friday's trading in the northern hemisphere (post the announcement from the euro area Heads of State or Government) tends to indicate that markets are cautiously optimistic about the future of the euro area, however, we remain in wait and see mode.

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