The Actuarial Profession
making financial sense of the future

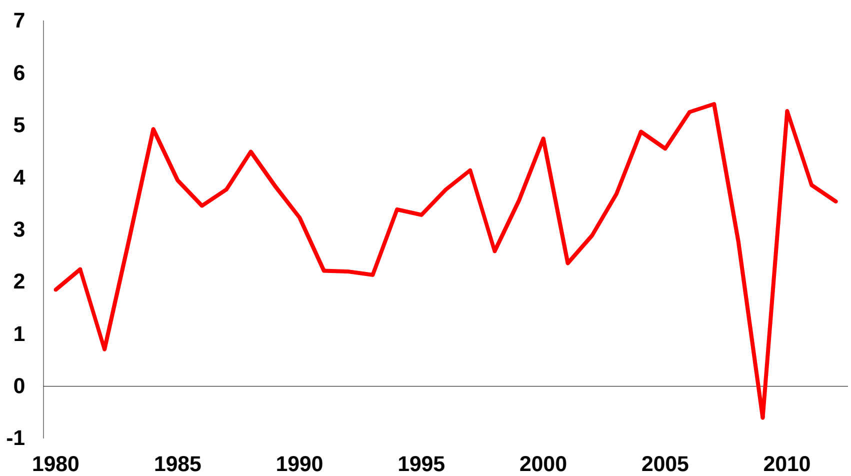
Current Issues in General Insurance (CIGI)

Andrew J Smith, Chief Economist, KPMG LLP

What's happening in Europe- An Economist's View

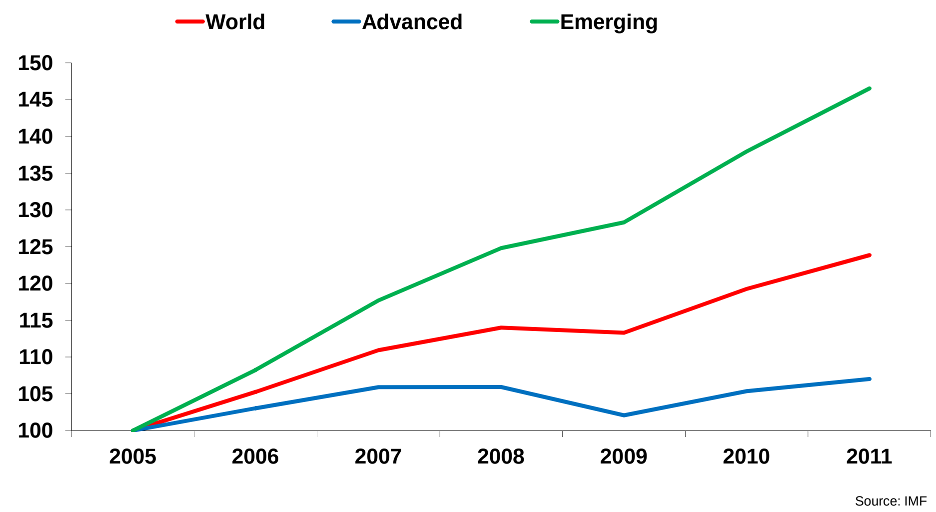
10 May 2012

World growth (% pa)

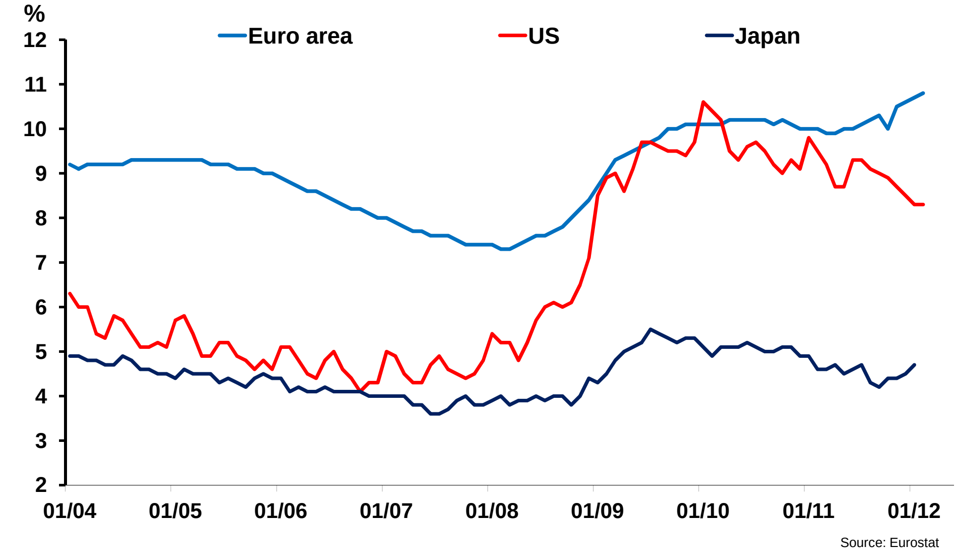


Source: IMF

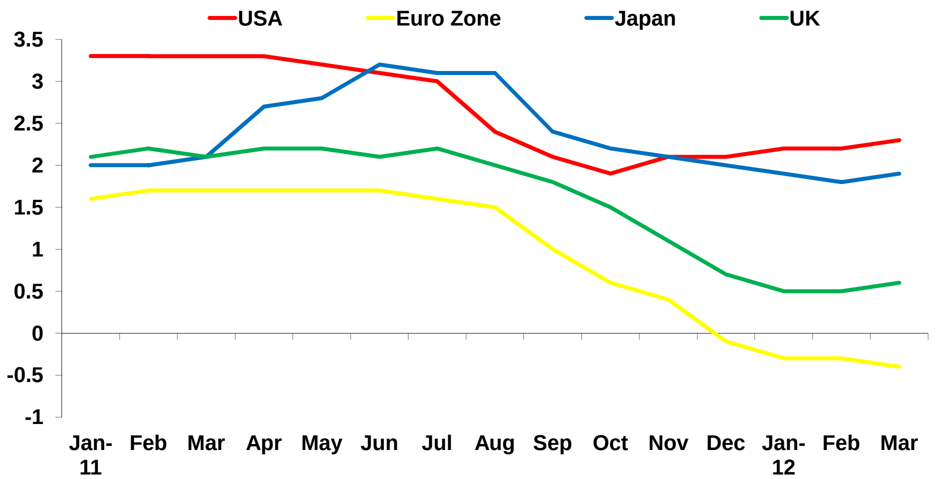
World output (2005 = 100)



Unemployment



Forecasts for GDP growth in 2012



Source: Consensus Forecasts

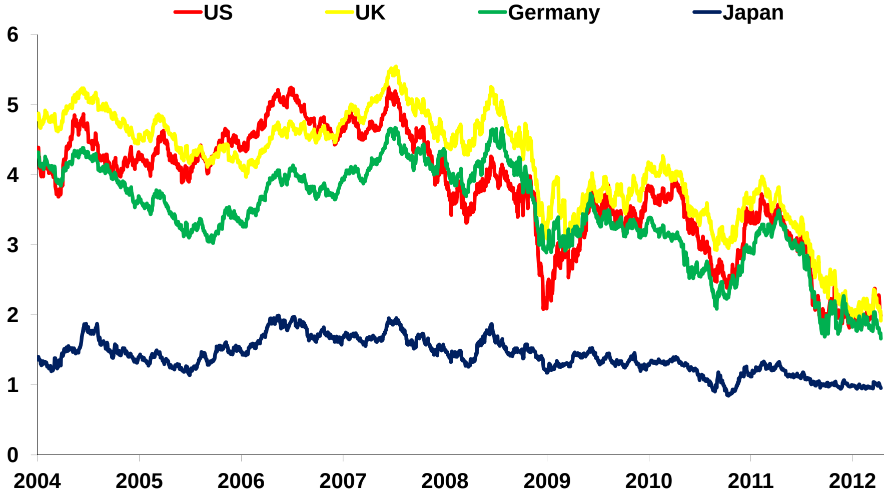
Why?

- Not a normal cyclical recession
  - Balance sheet recession
  - Liquidity trap
- Inappropriate policy
  - Concentration on deficit reduction when "it's demand, stupid"
- Eurozone mess
  - Lack of institutions and political will to resolve problems

Balance sheet recession

- Western world still suffering effects of financial crisis – under-priced debt, over-priced assets, over-stretched borrowers and under-capitalised lenders (and property main collateral)
- Private sector agents, including banks, concentrate on minimising debt as asset prices have collapsed but liabilities remain, reducing aggregate demand
- Government indebtedness initially rose in response, but led to solvency worries especially in parts of Europe
- “Expansionary fiscal contraction“ doesn’t work: austerity measures are pushing Europe towards another recession
- With interest rates at zero, monetary policy isn’t working either
- Risk of deflationary spiral as desired savings > desired investment even at 0 interest rates
- Where possible, governments should act as “borrower of last resort”
- UK and US in better position with record *low* government bond yields – but UK still has contractionary fiscal policy

Government bond yields 2004 to date (%)



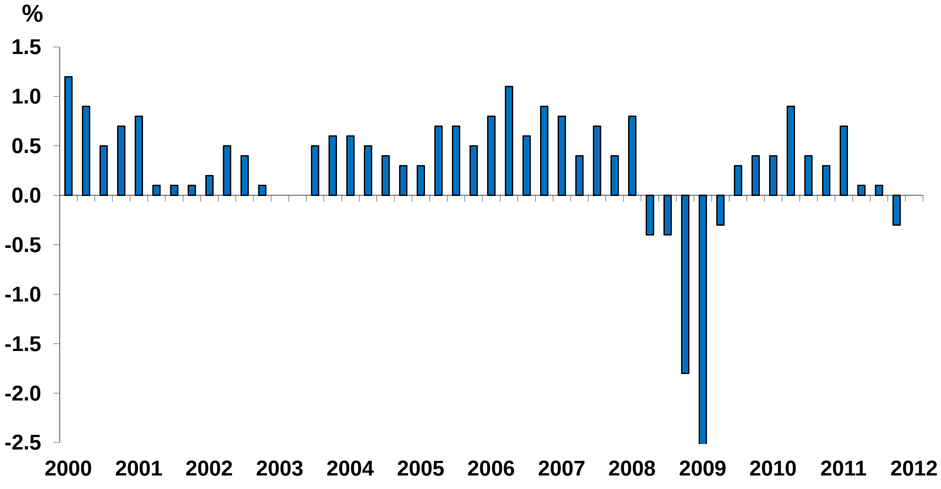
Source: Data Stream.

Annual growth forecasts - global

(%)	2009	2010	2011 (e)	2012 (f)	2013 (f)
US	-3.5	3.0	1.7	2.3	2.5
Japan	-5.5	4.5	-0.7	2.0	1.5
Eurozone	-4.3	1.9	1.5	-0.4	0.9
Developing Asia	7.2	9.5	7.8	7.3	7.9
China	9.2	10.4	9.2	8.2	8.8
Latin America	-1.7	6.3	4.2	3.6	4.0

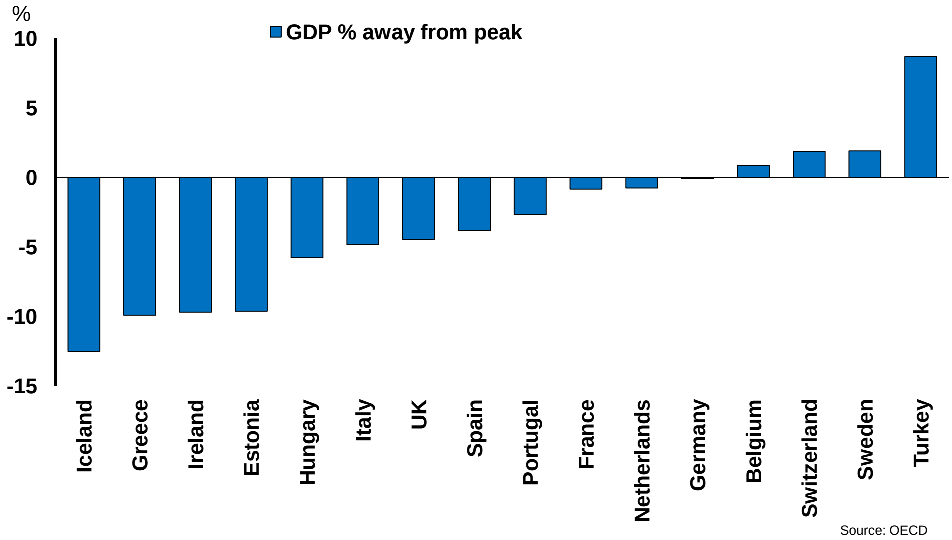
Source: Consensus Forecasts/IMF

Eurozone: GDP (quarter-on-quarter)

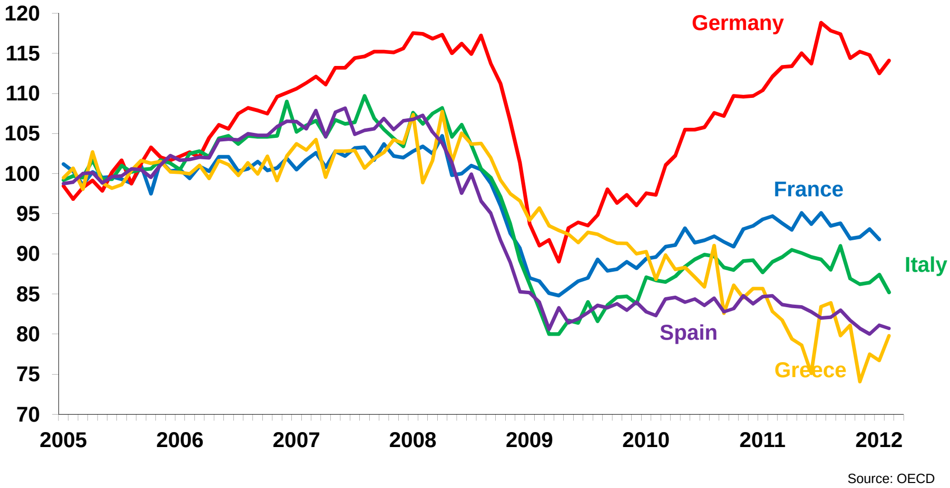


Source: Eurostat

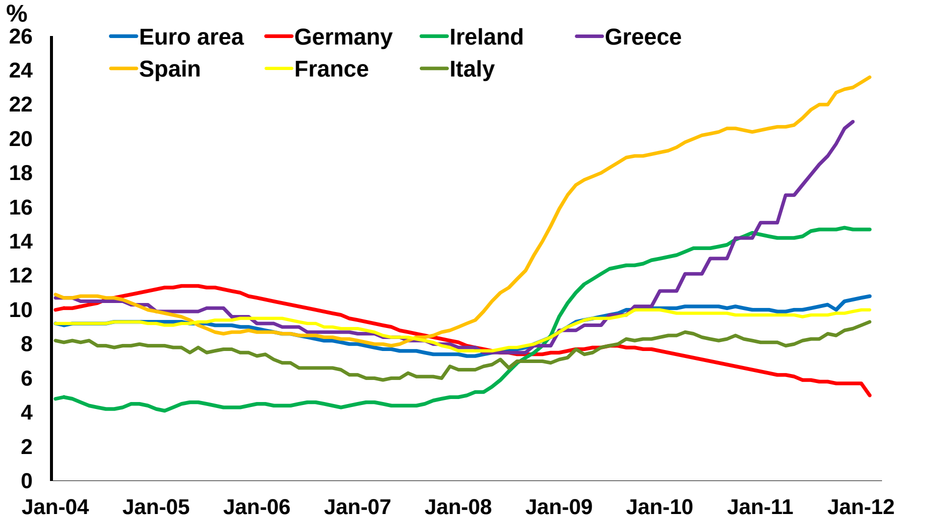
Europe – "recoveries to date"



Europe - industrial production index, 2005 = 100



Europe - unemployment



Source: Eurostat

How did Europe's periphery get in this mess?

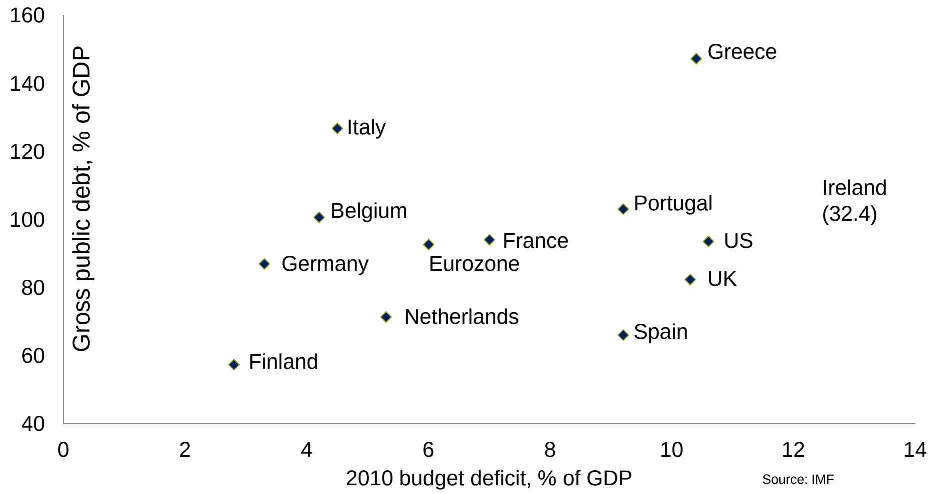
- Put divergent economies together in monetary union
  - High inflation economy + low interest rates = borrowing boom and loss of competitiveness
- In only a few economies was it government profligacy
- In others it was private sector debt explosion
- If it wasn't caused by government profligacy, not obvious austerity will solve it
- Why are investors in eurozone sovereign debt more concerned than others?
  - A monetary union without political/fiscal union
  - Effectively eurozone countries have borrowed in foreign currency (euros). So:

1) They can't print the money to service the debt

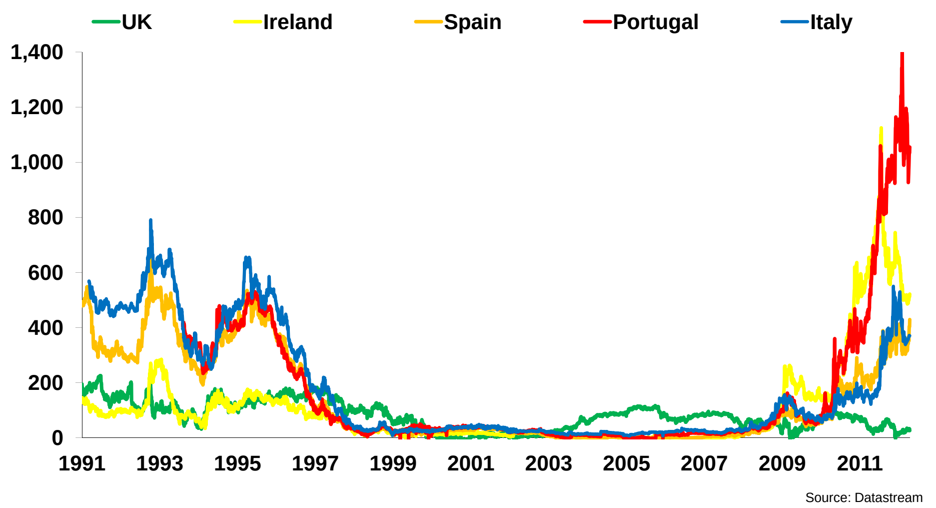
2) Investors can switch into other euro sovereign debt (eg Germany) without taking on currency exposure

3) So built-in potential instability which could be self-fulfilling

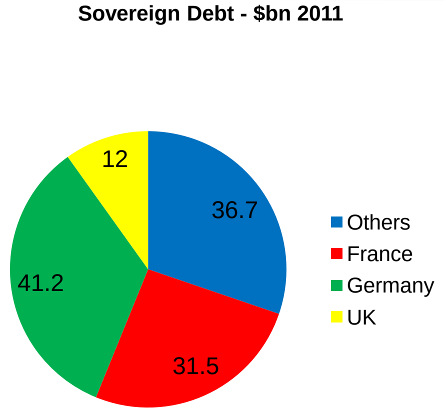
Public accounts (2010)

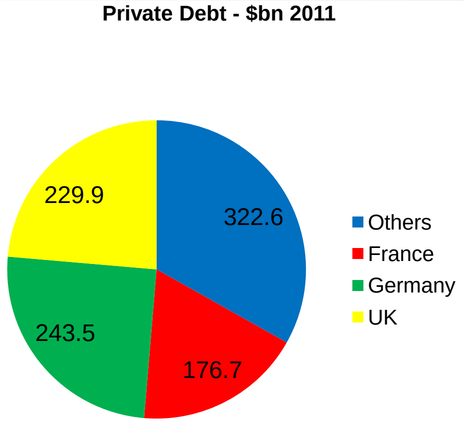


Government bond yield spreads (basis points over German govt bond yields)



Exposure of non PIGS European Banks to PIGS debt – 2011

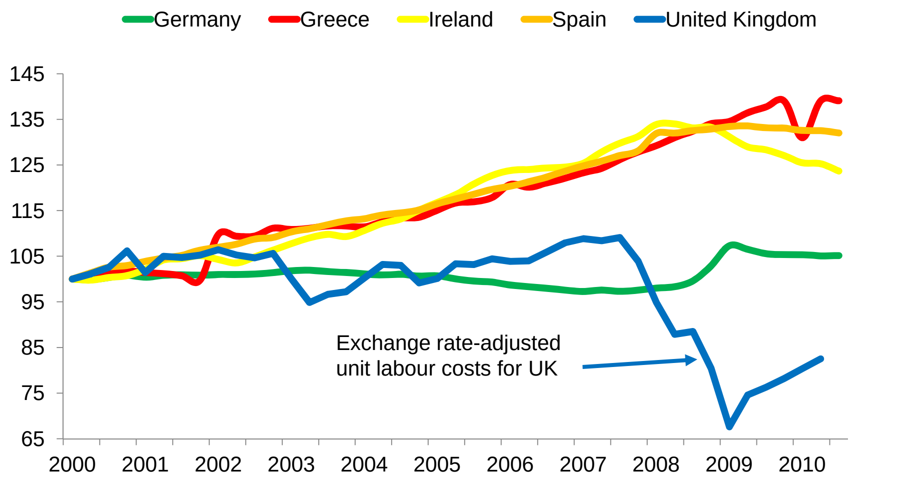




Note: In addition the ECB and ESFS also have exposure to sovereign and bank debt in Portugal, Ireland, Italy, Greece and Spain

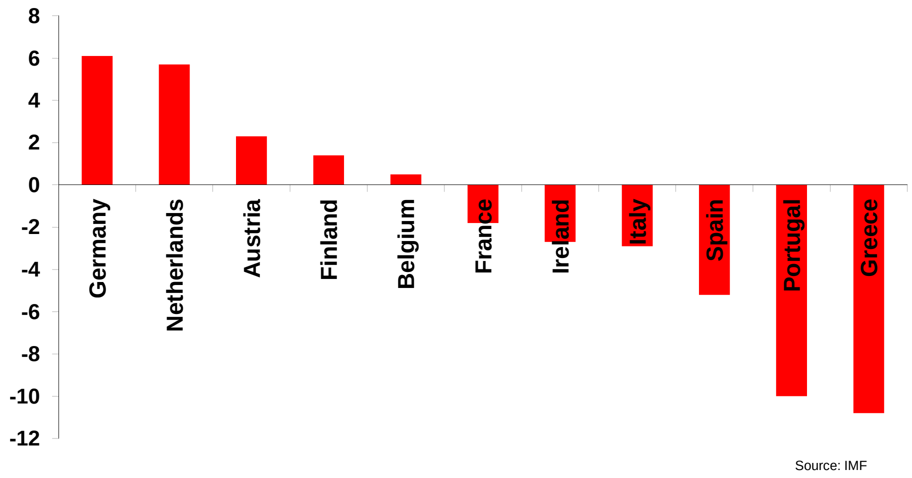
Source: BIS

Whole economy unit labour costs



Source: OECD

Current account balance (% of GDP) 2010



Eurozone sovereign debt – what happens?

- No bale-out, no default, no exit
- Peripheral economies face years of fiscal austerity and huge cuts in real wages
  - Not working in Greece – caught in death-spiral
- Germany seeing it as governance and competitiveness issue
  - Asymmetric adjustment
- EU has been treating it as liquidity issue - so too little, too late
- Market sees it as solvency issue
- A monetary union without fiscal union – or a central bank, or institutional framework to make quick decisions
- Can only end in ongoing German-led transfers, reflationary policy, or defaults/EMU exit
  - But management by crisis
- Latest Greek bale-out and PSI probably not the last required – debt/GDP 120% in 2020
- Conditionality – economically, politically and socially supportable?

Possible outcomes short of fiscal union

- **Muddle through**
- **"Isolated, disorderly" sovereign default**
  - Government unable to borrow; banks need to be re-capitalised
  - Increased cost/reduced availability of bank finance
  - Confidence effects and further austerity measures reduce demand
  - Euro weakens on fear of further defaults/ euro breakup
- **Greece leaves euro – drachma II falls**
  - Legal uncertainty over and mis-matches in denomination of assets/liabilities
  - Catastrophic for economy in short-term
  - But if Greece gains competitiveness and recovers – will others follow?
- **Germany leaves – DM II rises**
- **Euro breaks up**
  - Collapse of EU
  - Trade wars/competitive devaluations?

Short-term implications for companies

Risks for European companies:
- Weak European economy already impacting on UK businesses
- Escalation of crisis could have more serious consequences
- Supply chain risk

Break up risks:
- Currency risk – assets and liabilities mis-match
- Contract uncertainty/ rewriting

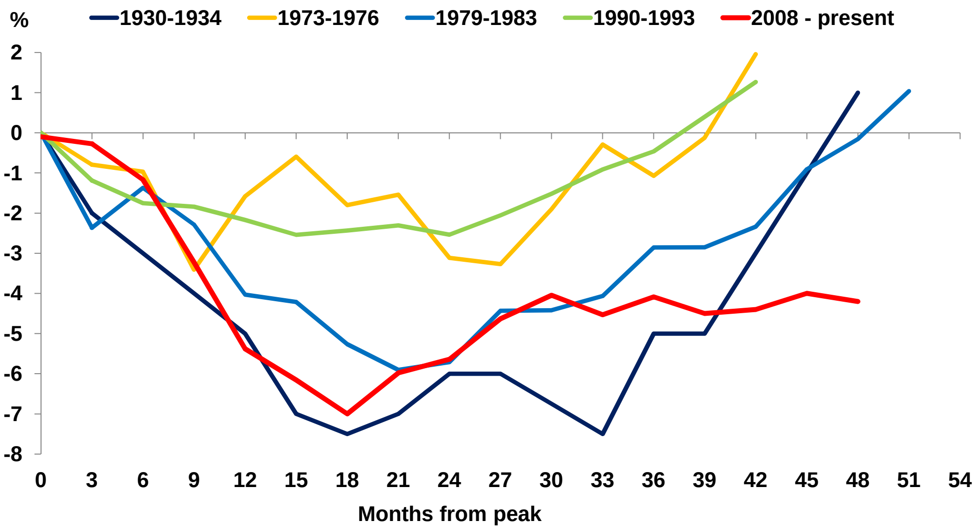
Contingency planning:
- Coping with commercial "sudden stop"
- Security of finance for ongoing operations
- Where to store assets – cash
- Debtor and creditor terms
- Coping with new currency
  - Pricing
  - Accounting systems
  - Re-write contracts

Annual growth forecasts – Europe

(%)	2008	2009	2010	2011 (e)	2012 (f)	2013 (f)
Germany	1.1	-5.1	3.7	3.0	0.6	1.5
France	-0.2	-2.6	1.4	1.7	0.2	0.9
Italy	-1.3	-5.2	1.2	0.5	-1.6	0.1
Spain	0.9	-3.7	-0.1	0.7	-1.4	0.1
Greece	-0.2	-3.3	-3.5	-6.8	-5.6	-1.1
UK	-1.1	-4.4	1.8	0.8	0.6	1.8
Ireland	-3.0	-7.0	-0.4	0.8	-0.4	1.3
Eurozone	0.3	-4.2	1.8	1.5	-0.4	0.9
E Europe	4.2	-5.2	4.4	4.7	2.5	3.6

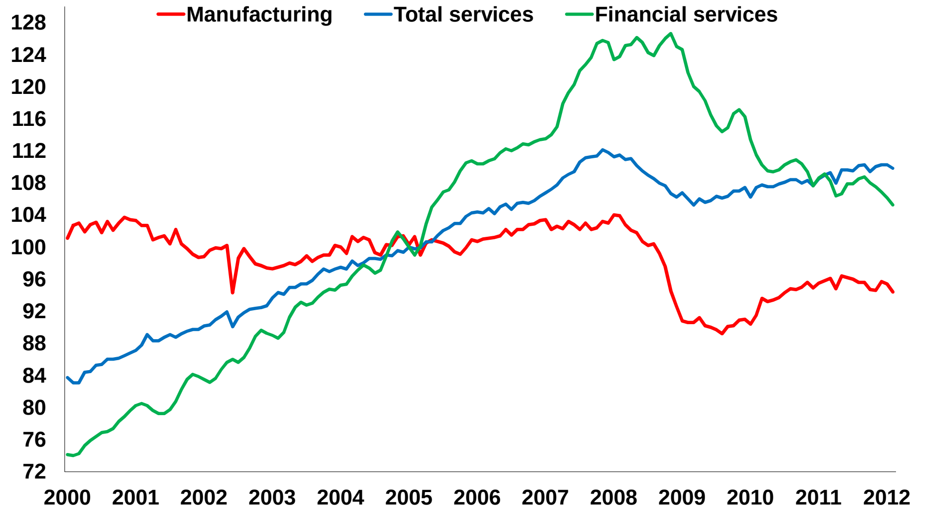
Source: Consensus Forecasts

UK – how recessions and recoveries compare



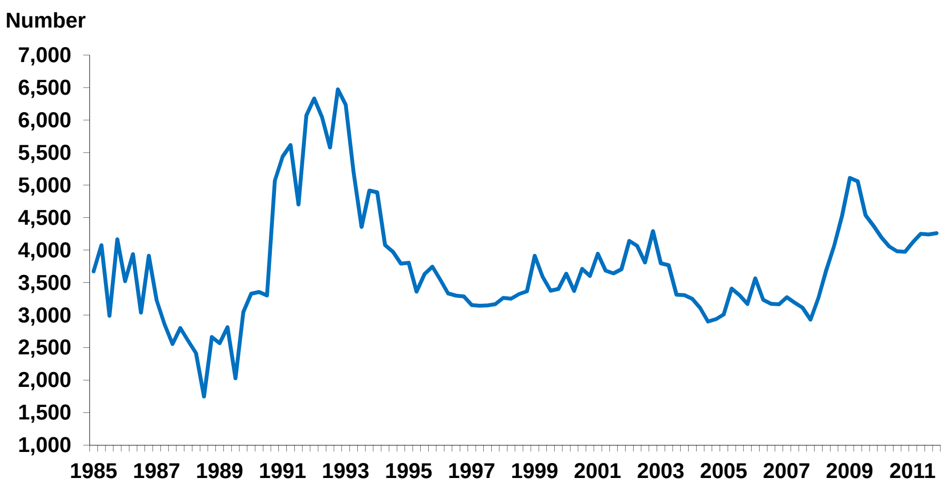
Source: ONS

UK manufacturing and services output (Level, 2005 =100)



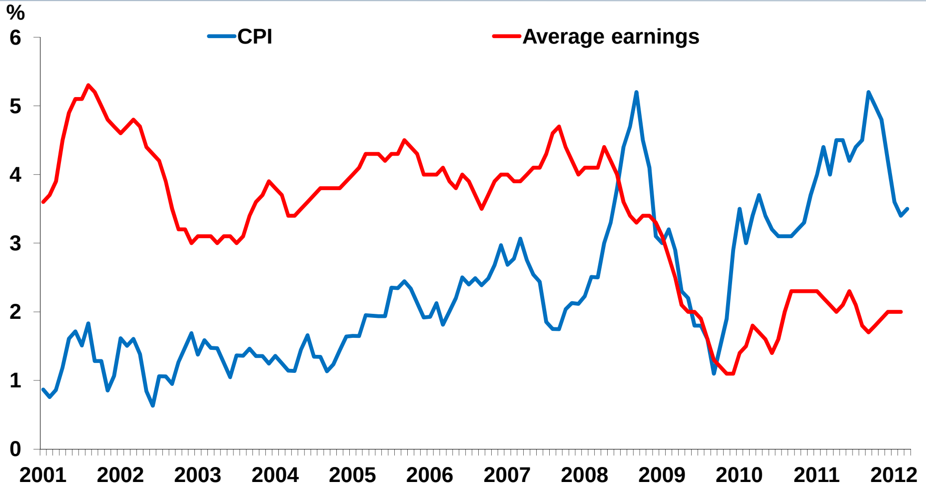
Source: ONS

Company insolvencies – England and Wales



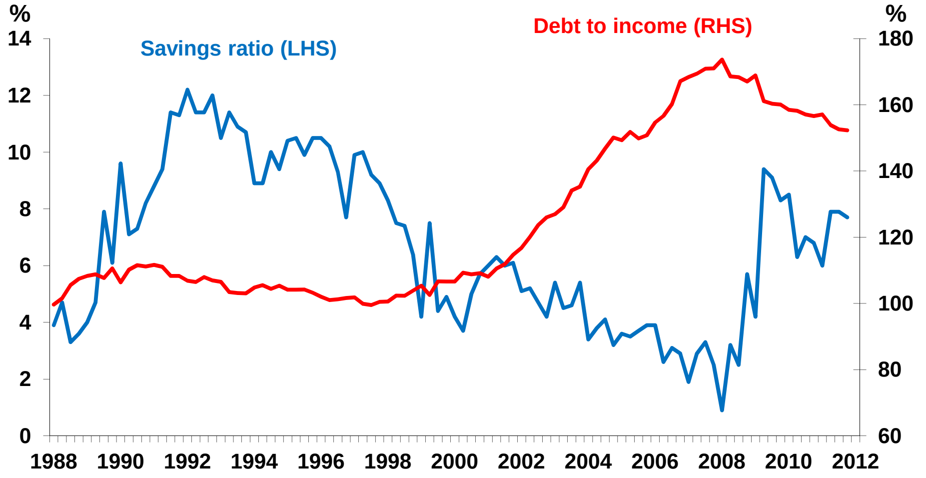
Source: DataStream

UK: inflation and earnings



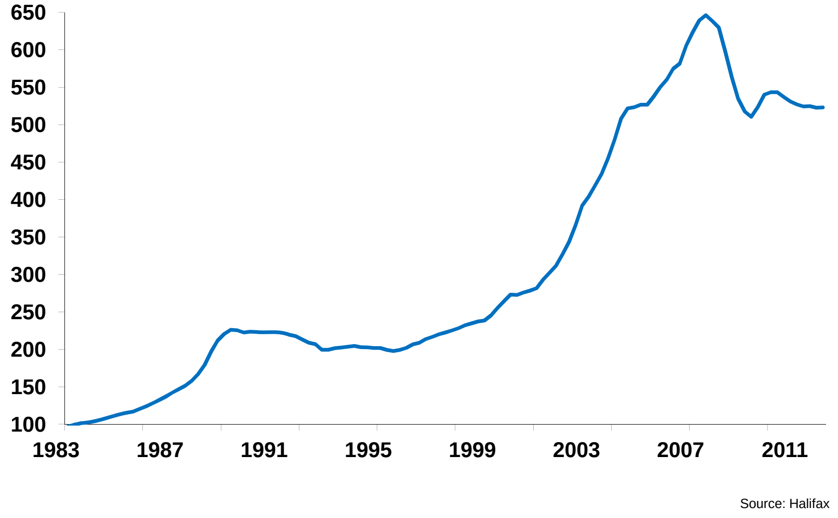
Source: ONS

UK: household debt to income ratio and household savings ratio

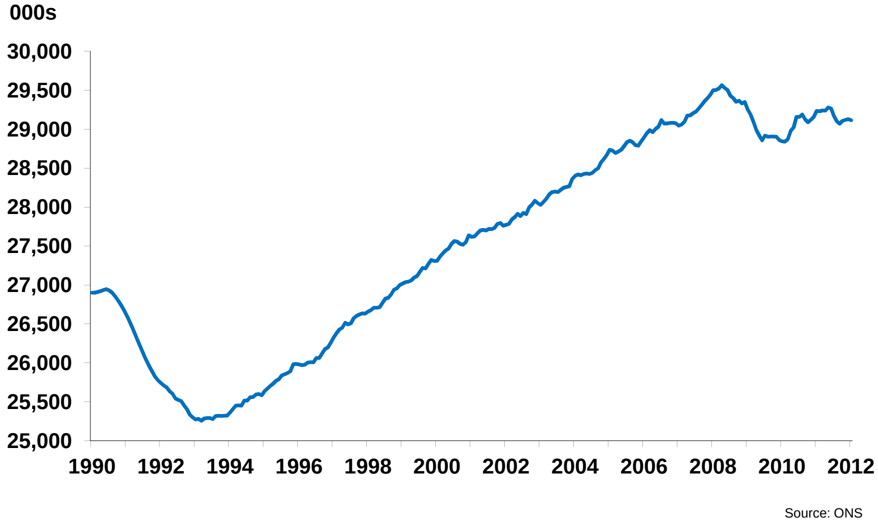


Source: OBR/ ONS

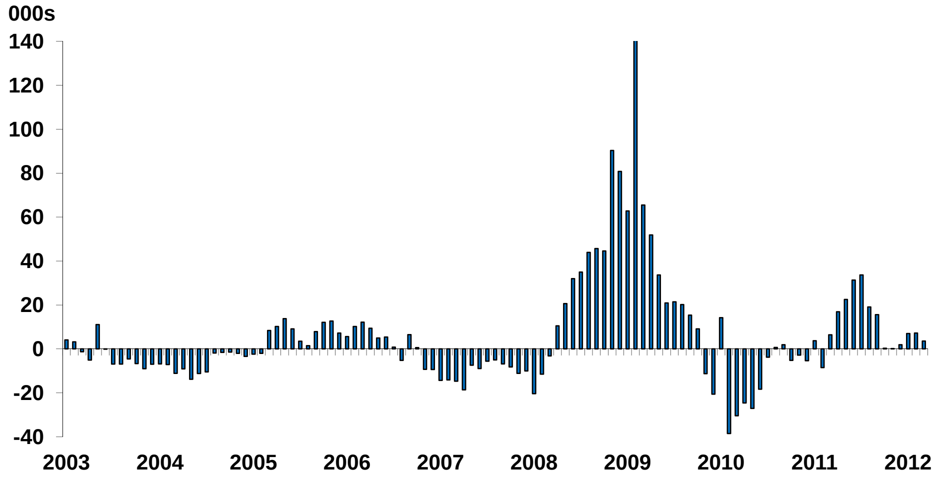
UK – house prices, 1983 = 100



UK – employment level

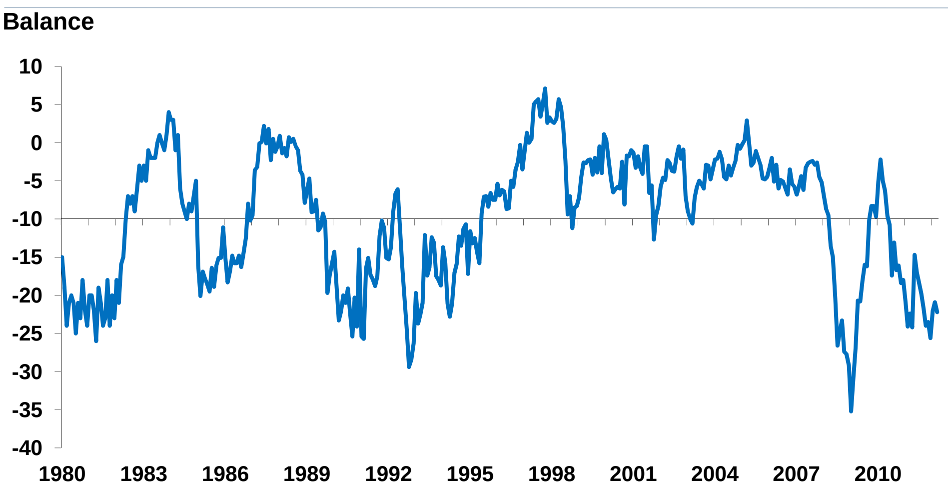


UK unemployment claimant count monthly change



Source: ONS

UK: consumer confidence

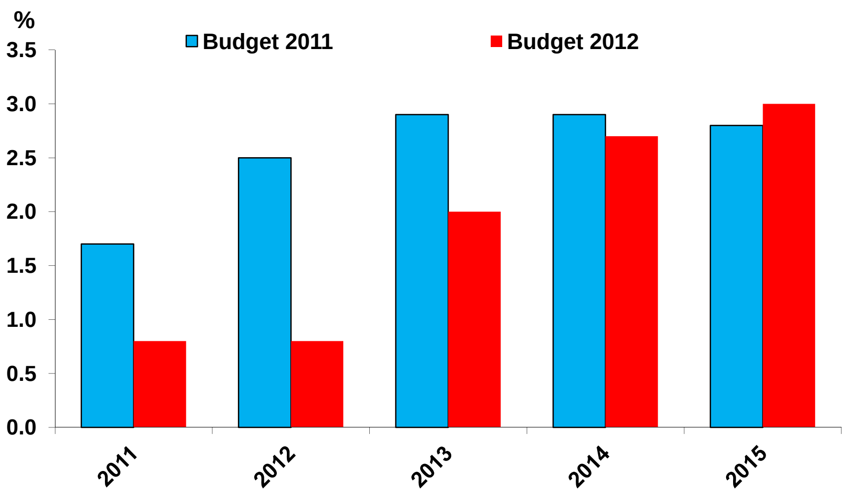


Source: DataStream

Osborne-omics – expansionary fiscal contraction

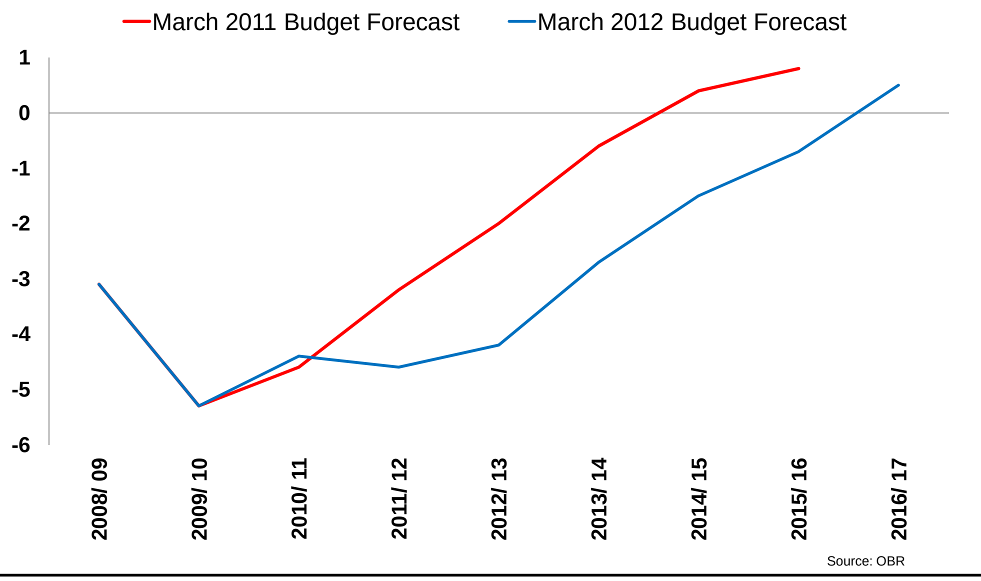
- Deficit reduction to return economy to growth
  - Structural current deficit reduced to zero in 5 years
  - Debt/GDP ratio to peak in 2015/16
  - No known economic theory or empirical evidence for it to be expansionary
  - TINA
- Rebalance economy
  - Export- and investment-led growth
  - Weak currency
  - Lower corporate taxes, enterprise zones, apprenticeships, et al
- What you could do
  - Run a bigger deficit to spend/invest more
  - Balanced budget multiplier
    - Raise taxes on high earners (savers) to finance government spending or to cut taxes for income constrained
- Risk that deficit reduction not only detrimental to growth but also counter-productive, with more debt in long-term

Change in OBR growth forecasts

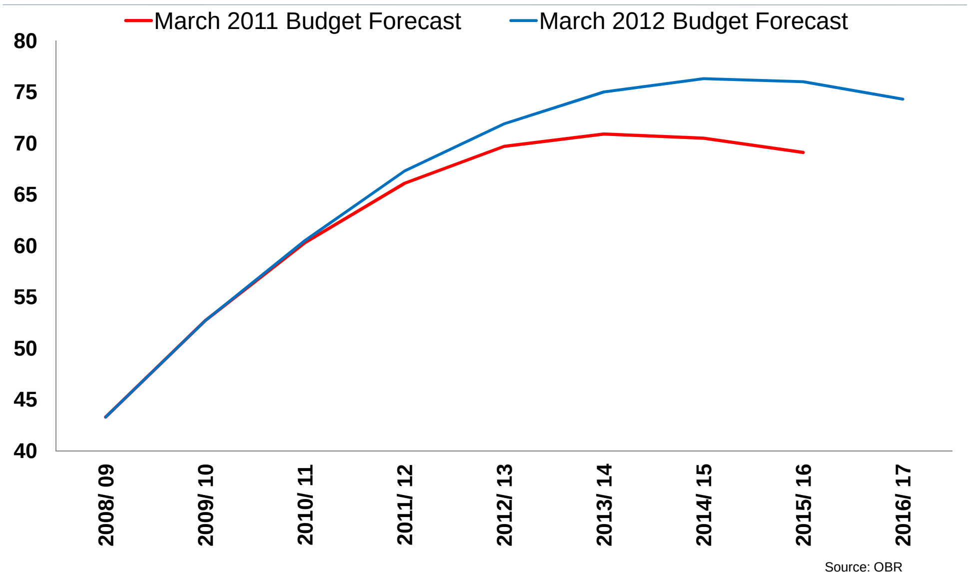


Source: OBR

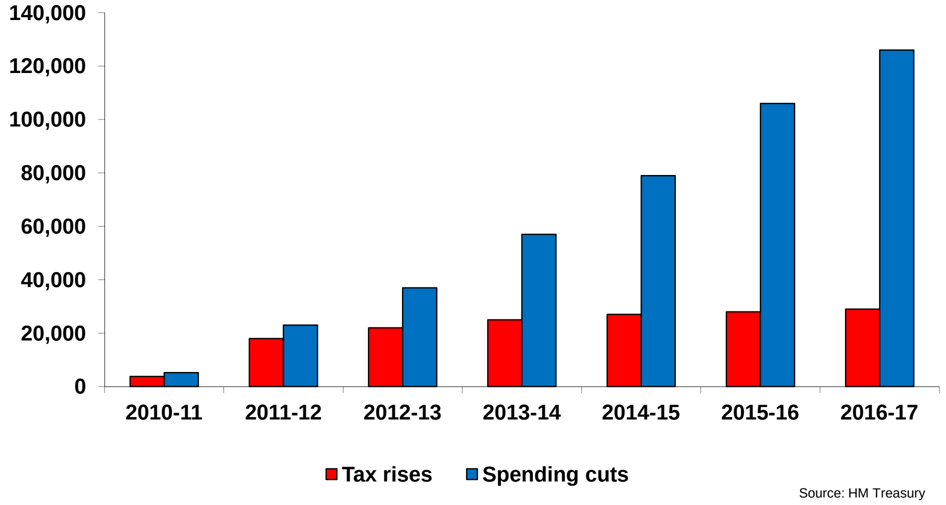
Cyclically-adjusted current budget deficit (% / GDP)



Public sector net debt (% / GDP)



Tax rises and spending cuts (£m)



Source: HM Treasury

Budget 2012 forecast

% change y-o-y	2011	2012	2013	2014
GDP	0.8	0.8	2.0	2.7
Household consumption	-0.8	0.5	1.3	2.3
Fixed investment - Of which business investment	-1.7 0.2	-0.3 0.7	6.2 6.4	8.6 8.9
Govt consumption	0.3	0.5	-1.1	-2.1
Exports	4.8	2.9	5.3	5.7
Public borrowing £bn	126	120*	98	75

* Excludes Royal Mail pension assets

Source: HM Treasury

Issues

- Markets – who/what is growing?
- Equities – blip or long-term change to economic fundamentals?
  - Have economies lost capacity? Will growth rate be permanently lower?
  - If so, what does it mean for valuations and returns?
- Bonds – will yields stay high in euro periphery and abnormally low elsewhere?
  - Risk-free assets?
- How reduce debt/GDP ratios?
  - Growth; austerity; explicit default/restructuring; inflation burst; steady financial repression plus steady inflation
- Inflation or deflation?
- Currencies – can you hedge against euro?