European Financial Developments

Ric Battellino, Deputy Governor*

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Introduction

Over recent months we have all watched with concern the growing financial problems in Europe. The problems are multi-dimensional, involving excessive government debt, weak banking sectors, slowing economic growth and marked differences in competitiveness across countries within the euro area. They have become the main threat facing the global economy and the international financial system.

It is hard to tell how and when the problems will be resolved. In the meantime, turbulence continues in global financial markets and most forecasters are now predicting a very significant weakening in the European economy over the coming year as government spending is cut back, credit tightens and confidence declines. Given the size of the European economy and financial system, it will be hard to avoid adverse consequences for other parts of the world, though the extent of these spillovers remains an open question. At this stage, most forecasters think that growth in the world economy will be only a little below trend in the coming year, though with the risk of a significantly worse outcome.

Australia, like other countries, will be affected by the events in Europe, but its strong government finances, healthy banking sector and relatively limited direct trade and financial exposures to Europe make it one of the countries best placed to weather the situation. Australia is also fortunate to be subject, simultaneously, to a resources boom that is resulting in unprecedented investment and therefore helping to sustain economic activity.

I will begin my talk today with a round-up of the European government debt situation. I will be brief as I think we all know the broad facts. I will then focus on the effect that the deterioration in government debt has had on European banks and the role that European banks are playing in spreading the problem to other countries. I will conclude by looking at the channels through which Australia could be affected, including through financial links, trade links and effects on confidence and wealth.

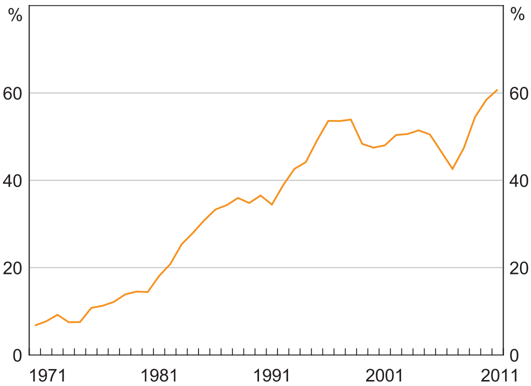
The European Debt Situation

As you know, the trigger for the problems currently being experienced in Europe was the rapid build up in government debt following the global financial crisis. Government budgets deteriorated sharply after 2008, due to the weakening in economic activity, the large fiscal stimulus applied by governments and, in some cases, the cost of bailing out banks.

Government debt in the euro area had been rising as a ratio to GDP, however, for much of the period since the 1970s (Graph 1). This occurred because governments loosened fiscal policy during recessions but did not fully reverse those policies during the subsequent cyclical recoveries. In aggregate, budgets in the countries that now form the euro area have been continuously in deficit for the past 40 years (Graph 2). Clearly, there was no fiscal rule that aimed to balance the budget over the economic cycle, as there is in Australia.

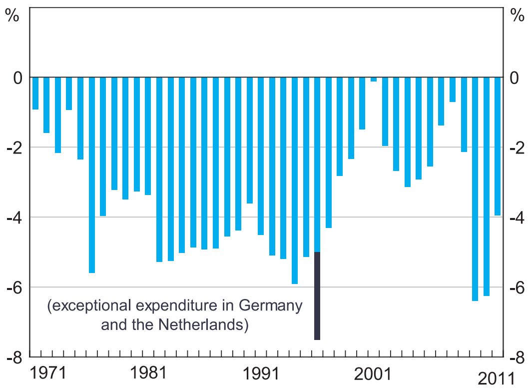
* I would like to thank Laura Berger-Thomson, Justin Fabo, Chris Stewart and Grant Turner for their extensive assistance with this talk.

Graph 1
Euro Area – Net Government Debt
Per cent of GDP



Source: OECD

Graph 2
Euro Area – Government Budget Balance
Per cent of GDP



Source: OECD

At the onset of the global financial crisis, the ratio of net government debt to GDP in the euro area was about 45 per cent and it has since risen to around 60 per cent. Within the euro area, Greece has the highest net debt ratio, at about 130 per cent, with Italy next, at about 100 per cent.

Concerns in financial markets about the sustainability of government debt levels in Europe first emerged in late 2009, when the Greek Government revealed that its fiscal position was significantly worse than it had previously led the markets to believe. Greek sovereign debt was downgraded and spreads on the debt widened, despite some fiscal tightening. By April 2010, the situation in Greece had deteriorated to the point where it was forced to seek external financial assistance from the IMF and other European countries.

As typically happens, market participants quickly began to ask which country might be next, and spreads in some other euro area countries also began to widen sharply. By November 2010, Ireland had been forced to ask for external assistance, and Portugal followed in April 2011. Recently, Italy and Spain have also come under severe financial pressure, though as yet have not needed external assistance.

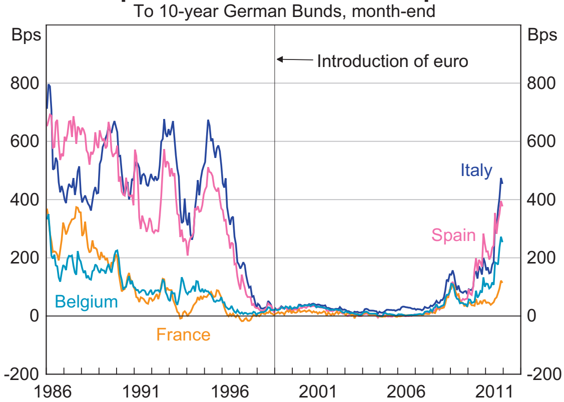
As the crisis has spread, a succession of measures has been announced to try to contain the problem, the latest being announced last weekend. These have typically provided some short-term respite, but in the past none has managed to provide lasting reassurance to financial markets. It remains to be seen whether the latest measures will be more successful. Most commentators see the long-term solution as involving greater fiscal coordination and discipline. In the short term, it is highly likely that part of the solution will involve substantial financial assistance from outside the region or the purchase of sovereign debt by the ECB, or some combination of both.

A sticking point here is that the ECB's charter precludes it from providing direct financing to governments. The ECB was initially also reluctant to buy government debt in the secondary market, though it has done so in substantial quantities recently. The restriction on the ECB's funding of governments was put in place both to guard against the risk of inflation and to avoid the moral hazard that would arise if national governments had direct access to central bank financing in a situation where there is no central coordination of fiscal policy.

While an arrangement where the central bank is precluded from direct financing of the government guards against the risk of inflation – that is, monetary instability – it increases the risk of financial instability. This is because if the central bank is not prepared to step in as a financial back-stop, a government that is unable to fund itself in the market is left with no option but to default or seek external assistance. It is highly unusual for a government in a developed economy to be forced to seek funding from an external party such as the IMF.

Concerns about the sustainability of debt levels have resulted in interest rates on government debt rising sharply in some countries, returning to the relativities that prevailed before the formation of the euro (Graph 3). Pre-euro, there was a wide variation in the interest rates paid by European governments, reflecting each country's history of inflation and fiscal discipline. The formation of the euro area brought convergence of interest rates towards the low levels previously enjoyed only by Germany, but pre-euro relativities are now reasserting themselves. This suggests that markets are pricing in the possibility of a break-up of the euro area or a significant risk of default by some governments, or both.

Graph 3
European Government Bond Spreads
To 10-year German Bunds, month-end



Sources: Bloomberg; Global Financial Data; Thomson Reuters

The Effect on European Banks

The problems in European sovereign debt markets have affected European banks through two main channels:

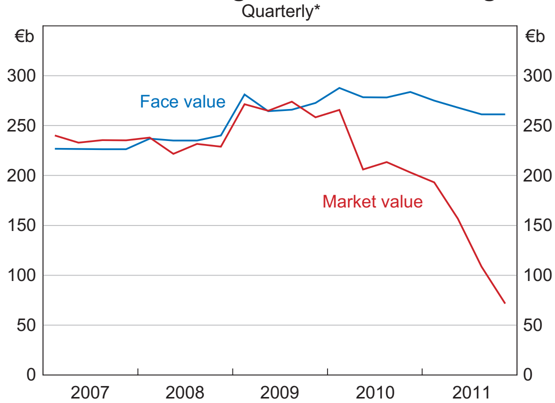
- first, these banks have experienced valuation losses on their sovereign debt holdings; and
- second, these losses have raised concerns about the financial soundness of banks, particularly in an environment where some governments are seen as having less capacity to support banks financially. This has caused investors and other banks to become reluctant to lend to them, and has pushed up banks' funding costs.

Let me say something about each of these points in turn.

Euro area banks, in total, hold about €2.5 trillion of euro area sovereign debt. This is about one-third of all the euro area sovereign debt on issue. The exposure is quite substantial, being equal to about 8 per cent of these banks' assets and 130 per cent of their Tier 1 capital. The majority of the debt held by banks in each country is home-country debt but, not surprisingly for a common-currency area, there are also large cross-border holdings. This is particularly the case for Italian debt, which is widely held by non-Italian banks.

Given the rise in yields that has occurred in some countries, the market value of the bonds has declined significantly. Greek debt, for example, has fallen in value by around 70 per cent. This means that even though the face value of Greek debt is about €260 billion, the market value of the debt is now only about €75 billion (Graph 4). Italian debt has fallen in value by 10 per cent. Banks have brought some of these losses to account already, but they remain heavily exposed to further losses if the situation continues to deteriorate.

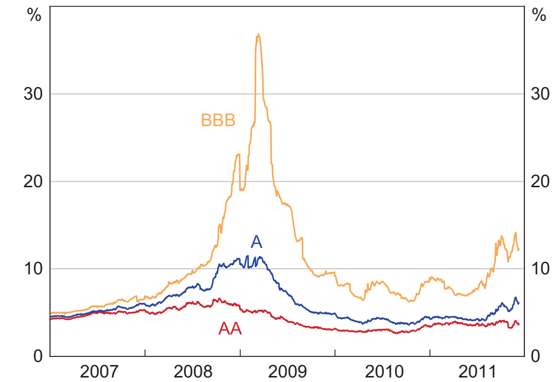
Graph 4
Greek Sovereign Bonds Outstanding
Quarterly*



* December 2011 figures are the most recent data
Sources: Bloomberg; RBA

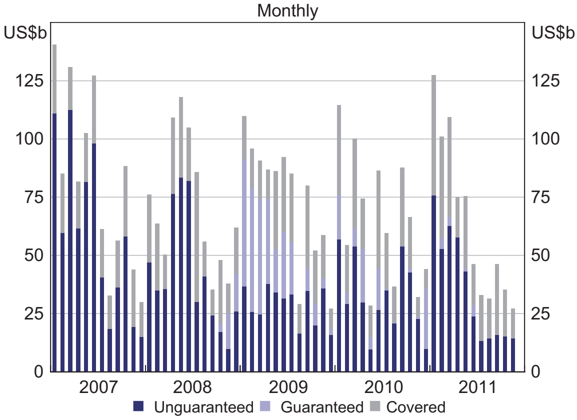
As I mentioned, concerns about these exposures have made investors and depositors more cautious. The cost of long-term funds has risen sharply (though it remains below that reached during the global financial crisis) and, for some euro area banks, bond markets have largely closed. As such, very few bonds have been issued by euro area banks recently (Graphs 5 and 6).

Graph 5
Euro Area Bank Bond Yields



Sources: Bank of America Merrill Lynch; Bloomberg

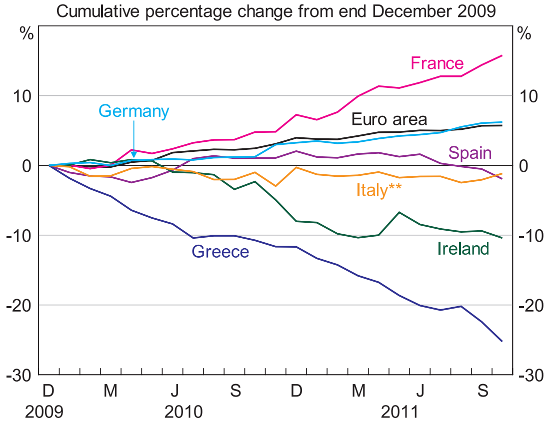
Graph 6
Euro Area Bank Bond Issuance
Monthly



Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

Banks in some euro area countries have also suffered large reductions in deposits. Greek bank deposits have fallen by about 25 per cent over the past couple of years and deposits in Irish banks by 10 per cent. Italian and Spanish banks have experienced a small fall in deposits. Banks in Germany and France, in contrast, have experienced increases (Graph 7).

Graph 7
Banks' Private Sector Deposits*
Cumulative percentage change from end December 2009



* Euro area deposits; includes deposits at other non-bank monetary financial institutions and deposits from non-central government; excludes repurchase agreements

** Excludes deposits associated with securitisations brought on balance sheet in June 2010 due to legislative changes

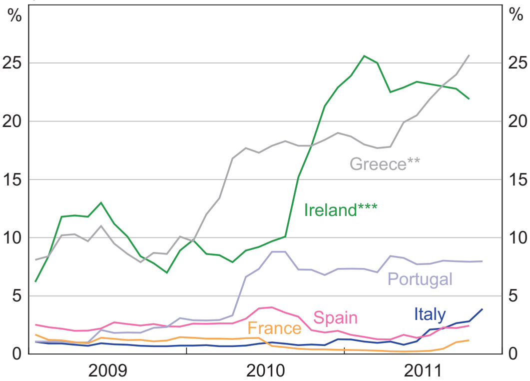
Sources: Banca d'Italia; ECB

With banks under funding pressure, the ECB has had to increase its lending to banks. Essentially, it currently allows euro area banks to borrow as much as they need (subject to the availability of eligible collateral) at its policy interest rate, for periods up to three years. Some banks have increased their use of ECB funding significantly: Greek banks and Irish banks are financing almost one-quarter of their balance sheets from either the ECB or their national central bank (Graph 8). For the banking system as a whole, however, central bank funding is equivalent to less than 3 per cent of liabilities.

European banks have also found it increasingly difficult to access US dollar funds, which they use to fund US dollar assets, including trade finance. Lending to euro area banks by US money market funds has fallen by 55 per cent this past year. In response, banks have turned to foreign exchange swap markets to source US dollars, pushing up the cost significantly (Graph 9).

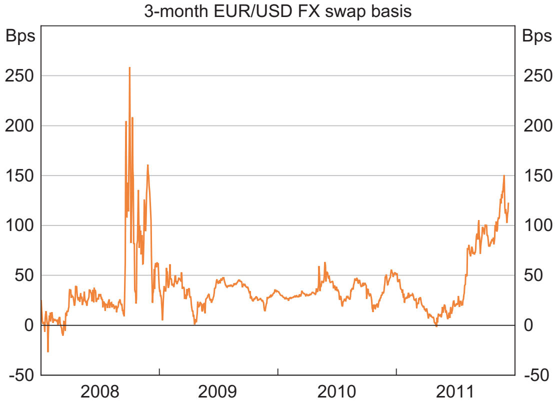
To alleviate the shortage of US dollar funds among European banks, the US Federal Reserve has reactivated its US dollar swap lines with a number of other central banks. This is to allow these central banks to lend US dollars to banks in their jurisdiction.

Graph 8
Central Bank Lending in Selected Euro Area Countries
By national central bank, per cent of national total bank assets*



* Banks proxied by credit institutions except France and Portugal which use the broader category of monetary financial institutions
** Includes estimate of emergency liquidity assistance
*** Domestic institutions covered by the government guarantee scheme only; includes estimate of emergency liquidity assistance
Sources: RBA; central banks

Graph 9
Cost of Swapping Euros into US Dollars*
3-month EUR/USD FX swap basis



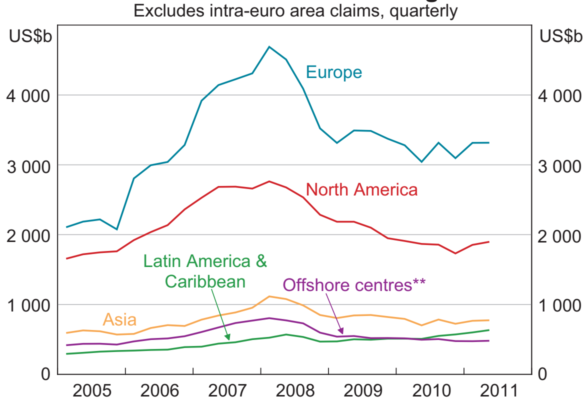
* Relative to the cost of unsecured interbank funding
Source: Bloomberg

Until recently, however, banks had not made much use of this facility, instead seeking to reduce their need for US dollars by selling US dollar assets and cutting back on cross-border financing. Following the recent reduction in the interest charged on the facility, however, usage has picked up somewhat.

To try to enhance investor confidence, European banking authorities recently announced a requirement for a large number of euro area banks to lift their core Tier 1 capital ratios to 9 per cent by mid 2012.[1] It has been estimated that, other things equal, this would require about €115 billion of new capital. This is not a particularly large amount, being equivalent to about 12 per cent of these banks' current capital. Nonetheless, there is evidence that at least some banks are unwilling or unable to raise equity and are seeking to achieve the higher capital ratio by reducing assets, particularly in offshore markets. This will add to the general tightening of global credit conditions.

Euro area banks are large participants in cross-border lending, though this is mainly oriented towards other European countries and North America (Graph 10). Their role in the Asian region is smaller, though they are thought to play a significant role in trade financing. While no data are available for the recent months during which the European banking problems have escalated, anecdotal evidence suggests that a lack of trade financing is not as significant a problem in Asia as it was in 2008.

Graph 10
Selected Euro Area Banks' Foreign Claims*
Excludes intra-euro area claims, quarterly



* Immediate borrower basis; not adjusted for series breaks and exchange rate effects
** Includes Hong Kong and Singapore
Source: BIS Consolidated International Banking Statistics

1 After including a buffer for valuation losses on their sovereign debt exposures.

Australia's Exposure to European Developments

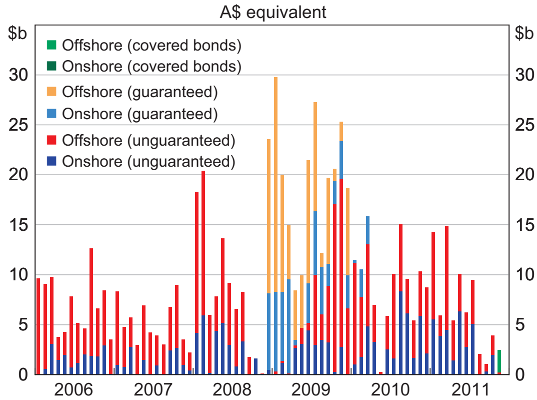
There are various channels through which developments in Europe could affect Australia. These include financial linkages, trade linkages and confidence and wealth effects.

Financial linkages

The direct exposures of Australian banks to the euro area are small. Their claims on euro area countries amount to $87 billion, or 2.7 per cent of total assets. Moreover, 80 per cent of this exposure is to Germany, France and the Netherlands (Table 1). The main effect of the European crisis on Australian banks is through the increased cost of funds in global markets. As debt has become more expensive, Australian banks have sharply reduced their issues of long-term debt (Graph 11). Short-term debt remains more readily available, particularly in the United States, where money market funds have shifted their investments from European banks to Australian, Canadian and Japanese banks.

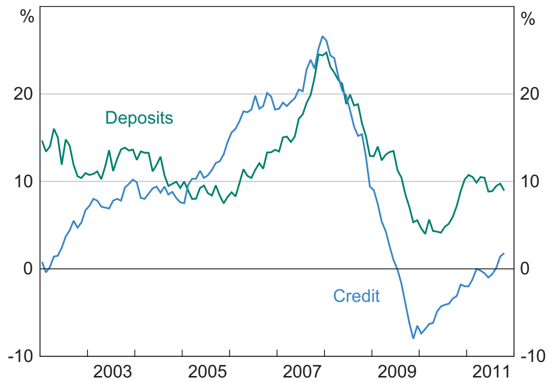
Australian banks, overall, remain relatively liquid as they continue to receive strong inflows of deposits. Over the past year, total bank deposits in Australia have risen by 9 per cent, which has been more than sufficient to fund the increase in banks' lending (Graph 12).

Graph 11
Banks' Bond Issuance
A$ equivalent



Source: RBA

Graph 12
Bank Credit and Deposits
Year-ended growth



Sources: APRA; RBA

Table 1: Australian-located Bank Claims on Euro Area Countries(a)
Ultimate risk basis, as at 30 June 2011

	Banks	Public sector	Private sector	Total	
	$billion	$billion	$billion	$billion	Per cent of assets
Euro area	66.2	4.1	16.9	87.2	2.7
of which:					
Greece, Ireland, Italy, Portugal and Spain	2.2	0.7	3.3	6.1	0.2
France, Germany and the Netherlands	59.2	3.0	12.4	74.6	2.3

(a) Australian-owned banks and subsidiaries and branches of foreign-owned banks; exposures include those to foreign-owned banks booked in Australia

Source: APRA

Trade links

The euro area accounts for only about 4 per cent of Australia's merchandise exports, a low share compared with many other countries (Table 2).

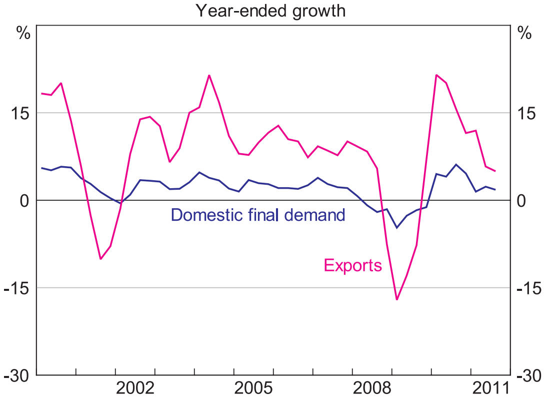
Table 2: Share of Merchandise Exports going to Euro Area
2010

	Per cent
United Kingdom	49
Sweden	39
India	15
China	15
United States	14
East Asia[(a)]	11
Japan	8
Canada	5
Australia	4

(a) Excluding re-exports from Hong Kong and Singapore and oil exports from Singapore
Source: ABS; CEIC; Eurostat; IMF; Office for National Statistics; RBA; Thomson Reuters

While the direct exposure of Australia to a slowing in European demand is low, the indirect exposure, through the effect on some of our important trading partners, could be significant. China and India, for example, both ship a substantial share of their exports to the euro area and these could be expected to decline. Further, history shows that, when exports slow, domestic demand in Asia also slows, albeit to a lesser degree (Graph 13).

Graph 13
East Asia* – Domestic and External Sectors
Year-ended growth



* Excluding China
Sources: CEIC; IMF; RBA; Thomson Reuters

Overall, it would be prudent to assume that, if the European economy were to slow markedly over the next year or so, Australia would be affected, particularly through indirect trade exposures. It is also likely, however, that if that were to eventuate, the exchange rate of the Australian dollar would fall, as it has when global growth has weakened in the past, providing some cushion for the Australian economy.

Confidence and wealth effects

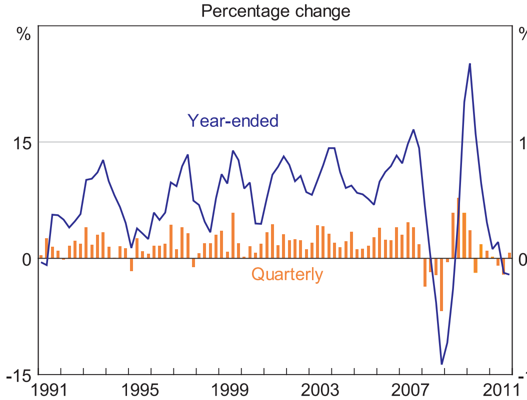
Confidence and wealth effects are difficult to quantify, but ultimately can be very important in transmitting economic shocks.

Household confidence in Australia was below average through much of 2011, with households being particularly pessimistic about their financial situation over the coming year. No doubt, these perceptions were being affected by the unsettling financial news coming out of Europe and the associated large declines in share prices. In recent months, however, measures of confidence have improved despite the escalating problems in Europe and the continuing volatility in share prices, suggesting that other factors are providing an offset. The changed picture for interest rates is one of these. However, the continuing solid expansion in household disposable income, which has risen by about 7 per cent over the past year, has no doubt also been important.

Measures of business confidence are a little below average at present, even though business conditions are around average levels. Conditions are weakest in the retail, manufacturing and construction sectors and are noticeably weaker among smaller businesses than among larger businesses. Overall, however, business confidence, like household confidence, has improved in recent months. The gradual spread of the benefits of the resource boom is helping to sustain business confidence in the face of the worsening European situation.

The key drivers of wealth are changes in share prices, house prices and deposits. Share prices are down by 10 per cent over 2011, though a significant part of this has been offset by higher dividend payments. House prices on average are down by 4 per cent in 2011. On the other hand, deposits have risen strongly and overall household wealth has fallen by a relatively modest 2 per cent in 2011 (Graph 14). This is a much smaller decline than occurred following the global financial crisis in 2008, and has not caused households to respond by sharply raising their rate of saving, as happened on that earlier occasion. This has allowed household spending to grow broadly in line with income.

Graph 14
Household Net Worth*
Percentage change



* RBA estimates for September and December quarter 2011
Sources: ABS; RBA; RP Data-Rismark

Conclusion

As the sovereign debt problems in Europe have escalated over recent months, an unfavourable feedback loop has developed between government debt, the banking sector and the economy. The large size of the euro area economy and the significant role played by European banks in global cross-border banking mean that it is inevitable that there will be spillovers to other parts of the global economy, including Australia.

Nonetheless, it is encouraging that, to date, any impact on the US economy has been more than offset by other factors, with recent US economic indicators being better than they were around mid year, despite the recent escalation of the European crisis. The same is also true in Australia. Asian economies have slowed, but it is not clear how much of this is due to earlier policy tightening within Asia (which in some cases is now being reversed as inflation pressures subside) or the effect of the developments in Europe.

The situation is still unfolding, however. The impact on the global economy will ultimately depend on how the European problems are resolved. It is possible that a combination of credible fiscal commitments by governments and short-term support from the ECB and IMF will provide a solution that is relatively benign for the European and world economies. However, other outcomes, including deflation caused by prolonged fiscal austerity, inflation caused by large-scale debt monetisation, or some disruptive event such as a change in the composition of the euro area, cannot be ruled out at this stage.

We therefore need to monitor the situation carefully and remain alert to the risks. Having said that, I remain confident that Australia, with its strong government finances, resilient banking system, relatively low exposures to the troubled countries and strong links to the dynamic Asian region, is well placed to deal with events that may unfold. ✠