

# All you ever wanted to know about European austerity plans...

(...but were afraid to ask)

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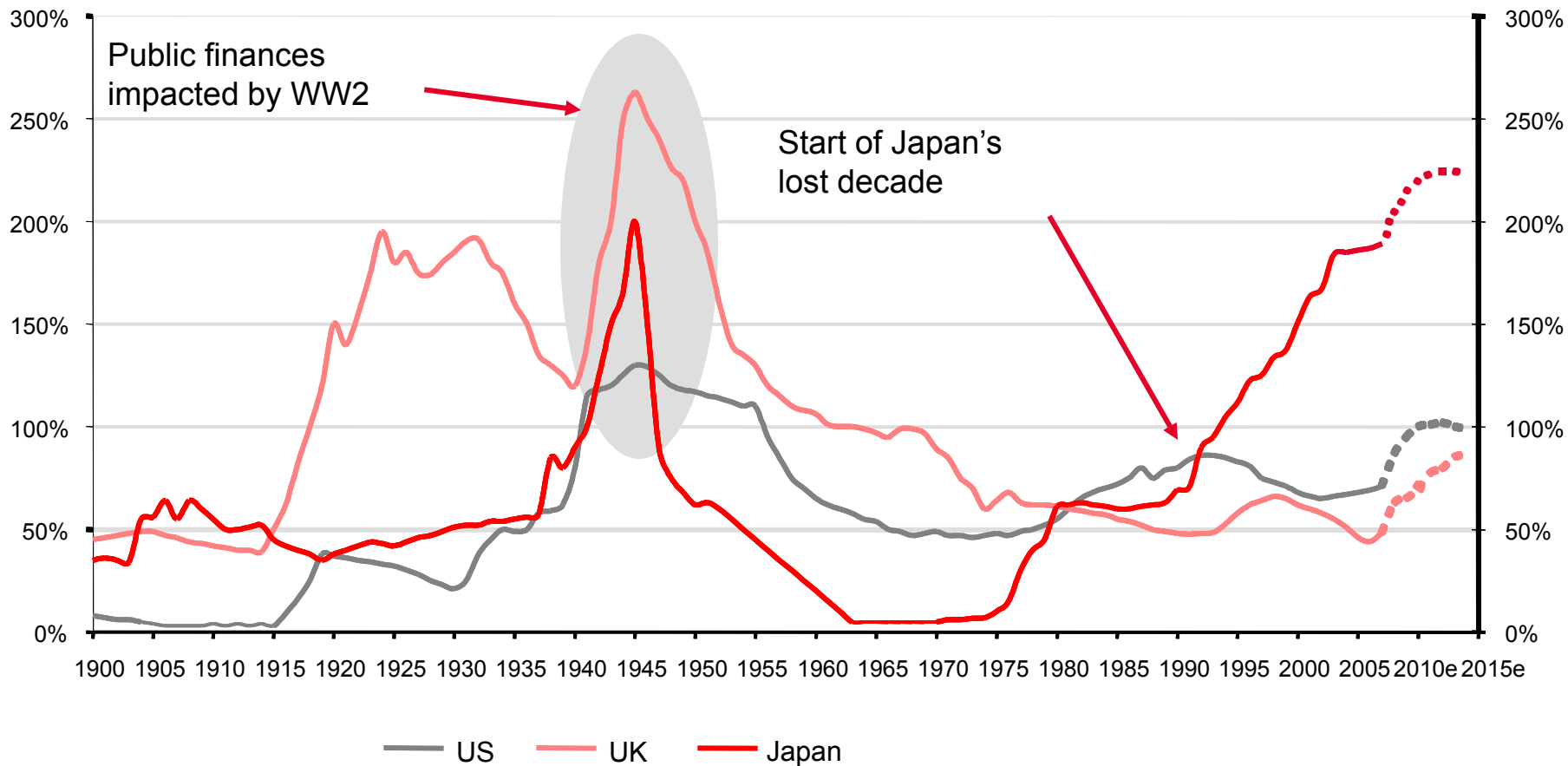


**SOCIETE GENERALE**  
Cross Asset Research

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# Austerity Plans - Kill or Cure?

## Public debt/GDP – 1900/2015e

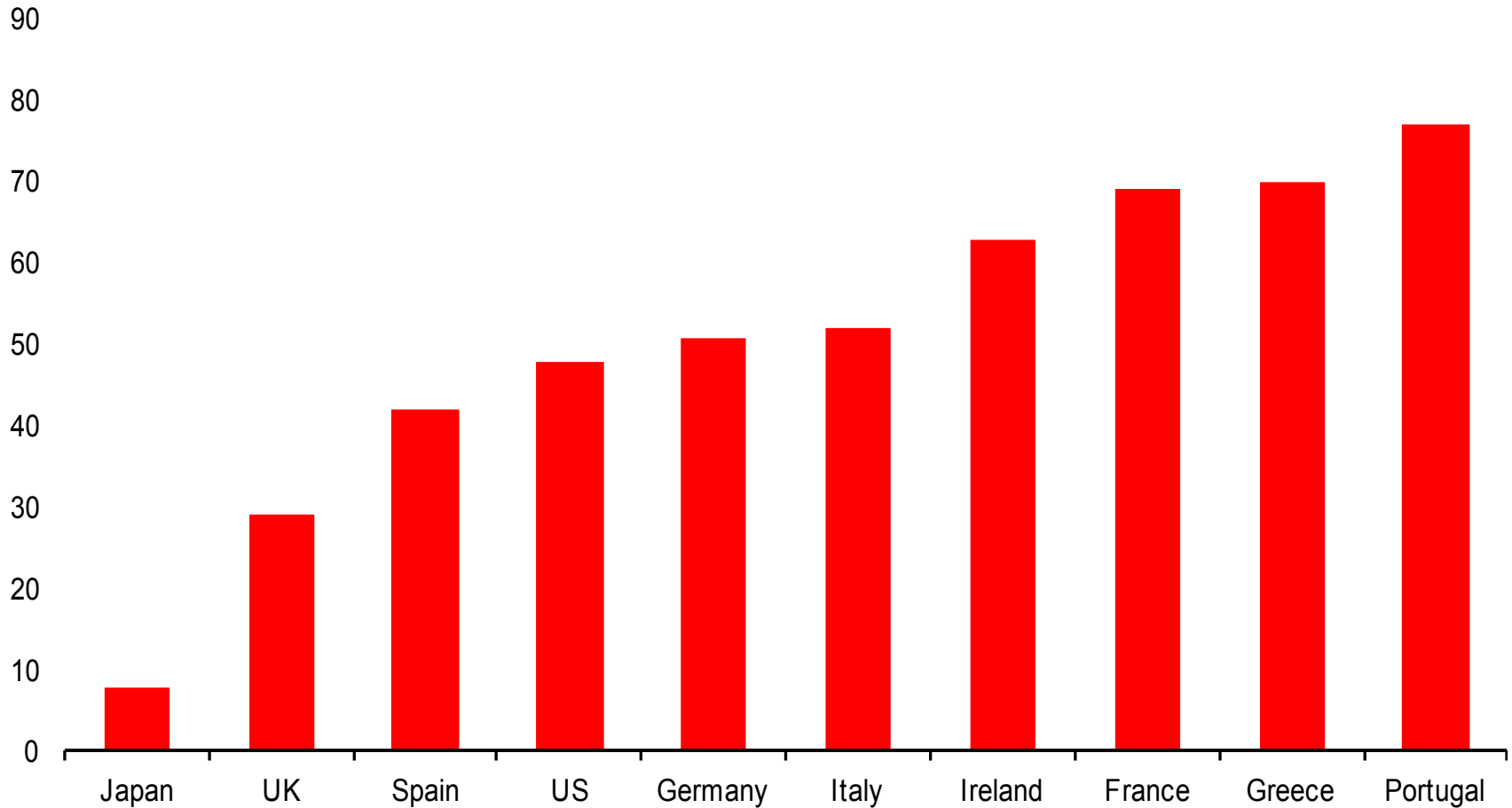


## Question 1

**Why is it necessary for European countries to deliver austerity plans?**

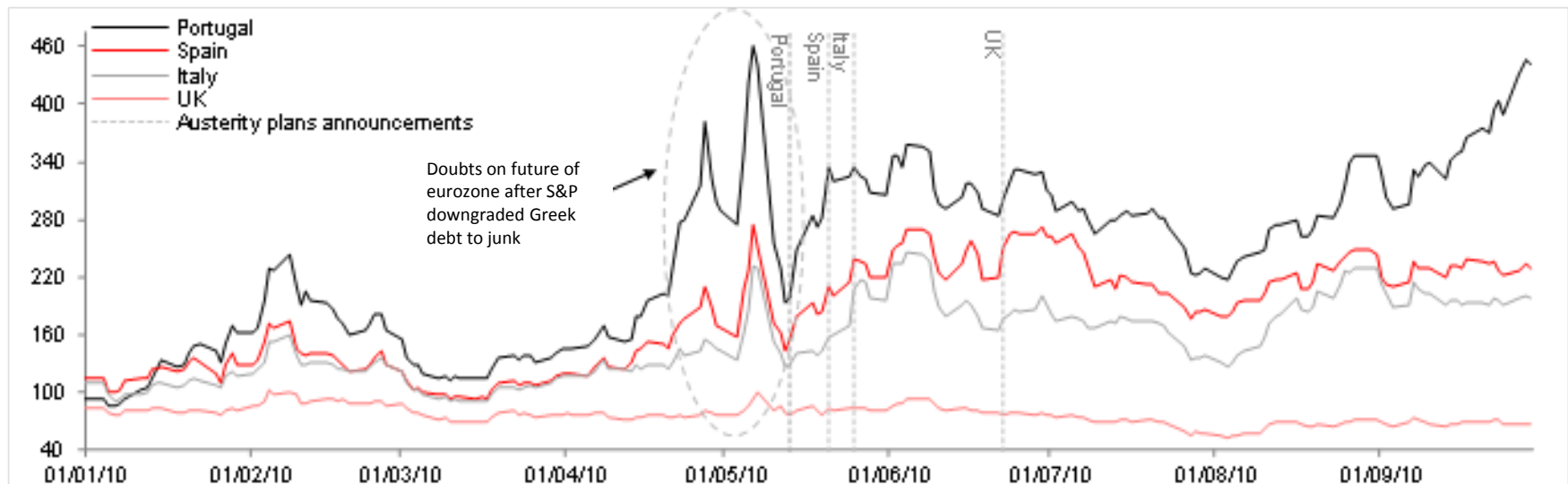
*“In the middle of every difficulty lies opportunity”.*  
*Albert Einstein*

## European government debt is held by non residents (%)



# Fears of higher cost of debt fully justified

## Senior 5-year CDS (bp) and austerity plan announcements: a limited impact



# Debt remain a major threat for developed economies

## Question 1

Why is it necessary for European countries to deliver austerity plans?

## Answer 1

*Because, if governments do not rapidly address their debt problems, the cost of debt could explode, as in Greece. Thus, fears of escalating interest rates and the resulting dire consequences for their economies are seen to justify the need for austerity measures.*



## Question 2

# What do we really know about the different austerity measures?

*“Waiting is painful. Forgetting is painful. But not knowing which to do is the worst kind of suffering”  
Paulo Coelho.*

# Recap of austerity measures

## Overview of European austerity measures

Country	Debt to GDP 2011e	Budget Balance 2011e	Austerity plan details				Spending cuts	Pension reform	Tax increases
			Size €bn	Size, % of GDP	%	Years			
<b>Greece</b>	<b>129.4</b>	-7.0	35	17	3	State salary freeze until 2014 Holiday bonuses partly abolished	Pensions freeze until 2012 Retirement age extended to 65	VAT raised from 21 to 23% One-off tax on companies	
<b>Italy</b>	<b>119.2</b>	-3.9	24	2	3	State salary freeze for 3 years €13bn of spending cuts 2011-12	Retirement pushed back by 3 to 6 months	New taxes on stock options and bonuses Possible expansion of toll roads	
<b>Belgium</b>	<b>97.9</b>	-4.0	22	15	5	Elections and regional divisions are delaying a clear deficit reduction strategy			
<b>Portugal</b>	<b>86.1</b>	-4.6	11	7	4	5% pay cuts for public sector Sell €6bn of state assets (e)	-	VAT increased from 20% to 21% and then to 23% Crisis tax created	
<b>France</b>	<b>87.7</b>	-6.0	45	3	3	3-year freeze on public spending State subsidies cut by 10%	Retirement age raised from 60 to 62 by 2018	Top rate income tax to 41% Taxes raised on capital gains + life insur.	
<b>Ireland</b>	<b>92.8</b>	-11.1	4	2	2	3 austerity budgets over a year. Public sector salaries cut by up to 15%	-	VAT up from 21% to 21.5% 2008 +2% on top income tax rate	
<b>Germany</b>	<b>69.3</b>	-3.8	80	4	4	Welfare spending cut by €30bn Cut in public sector payrolls	-	Taxes on nuclear power plants Financial transaction tax	
<b>UK</b>	<b>73.4</b>	-7.5	110	9	5	25% cut in government spending	Retirement age raised from 65 to 66	VAT up from 17.5 to 20% Total of £40bn in tax increases	
<b>Spain</b>	<b>68.7</b>	-6.5	15*	1	2	Civil service payrolls cut 5% in 2010 €6bn cut in public sector investment	Pensions freeze	VAT up from 16% to 18%, and 8% from 7%	

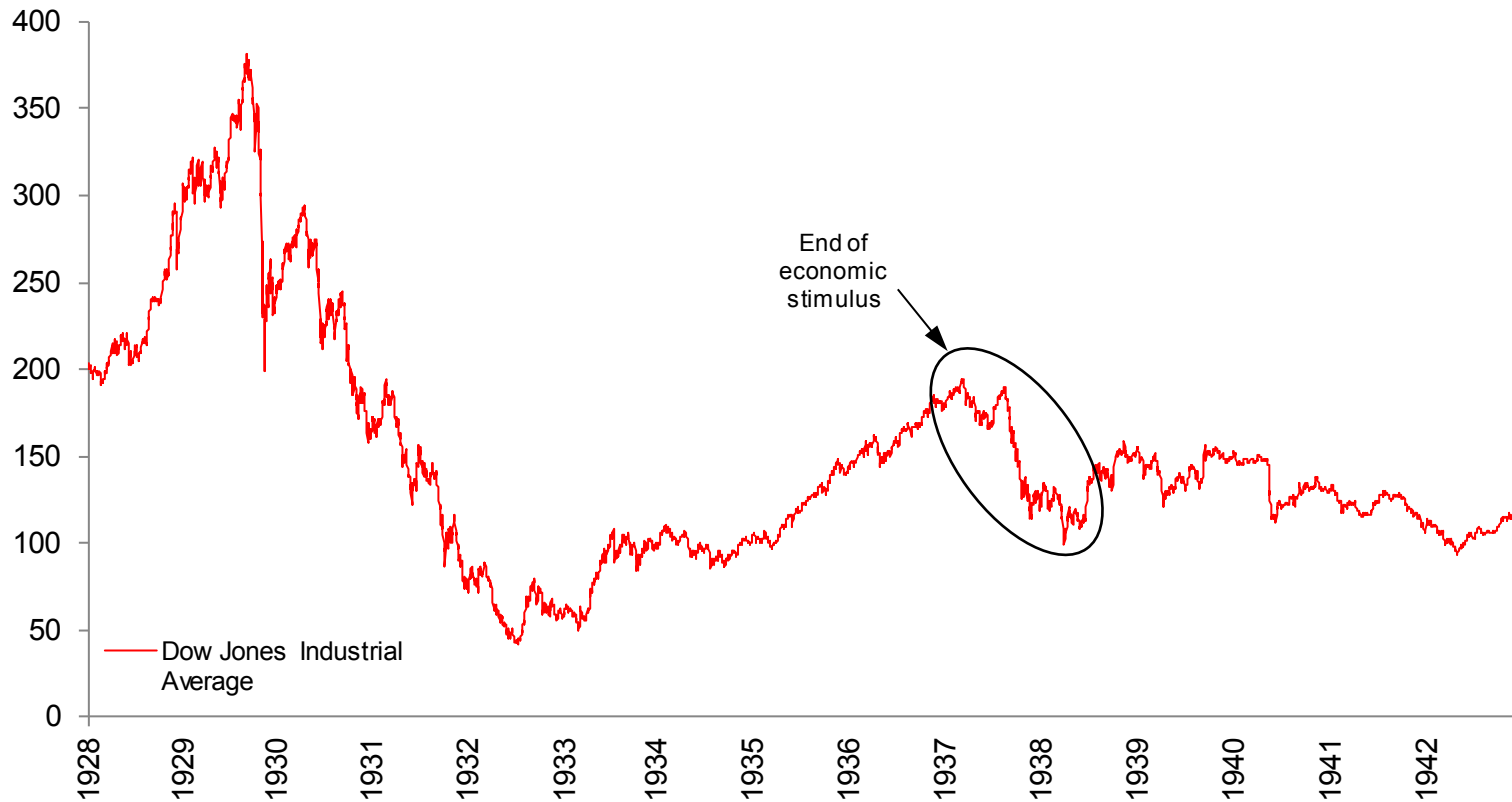
Source: SG Cross Asset Research

\*Agreed €15bn cost-saving plan in May on top of an €50bn package in January. So €65bn overall



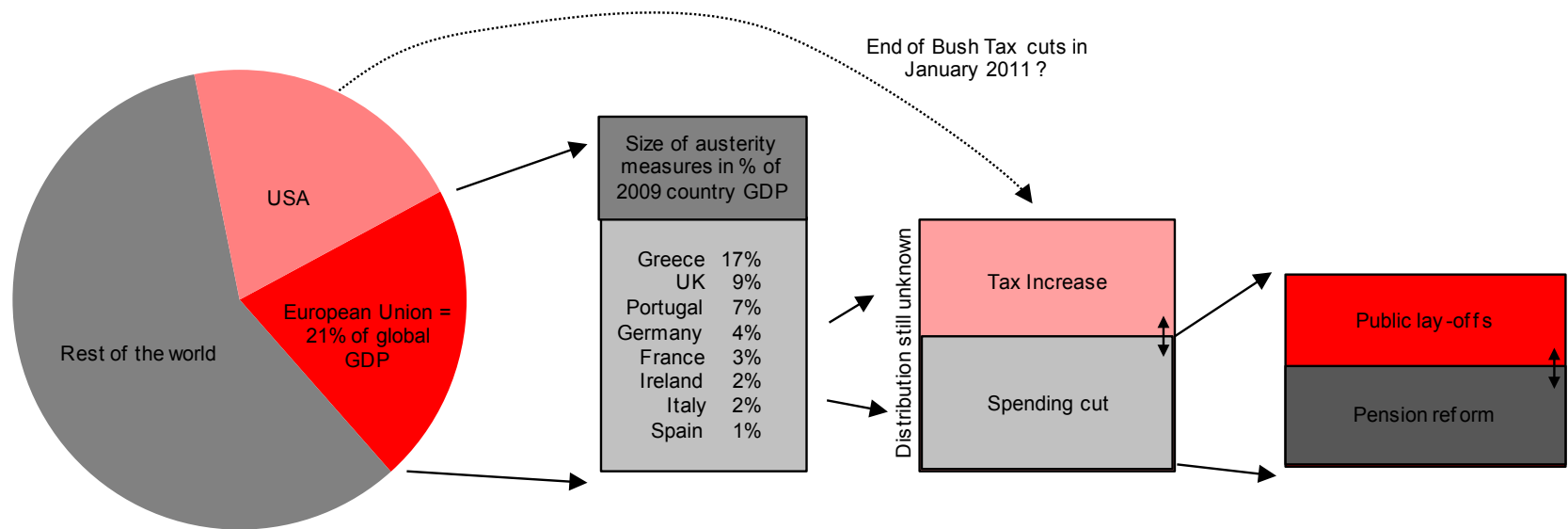
# Fears of 1937 rerun in the US at the end of economic stimulus

## End of economic stimulus: consequences on equity markets



# End of Bush tax cuts for the US in 2011

## Many European countries on the road to austerity



Source: SG Cross Asset Research

# Still plenty of fog

## Question 2

What do we really know about the different austerity measures?

## Answer 2

*At present all we know is that the austerity plans in Europe will represent more than €350bn or 3% of European GDP for the next four years.*



## Question 3

**Do past examples fully justify these austerity measures?**

*“Keep your eyes on the stars, and your feet on the ground”.*

*Theodore Roosevelt*

# Fiscal adjustments take an average 8 years to succeed

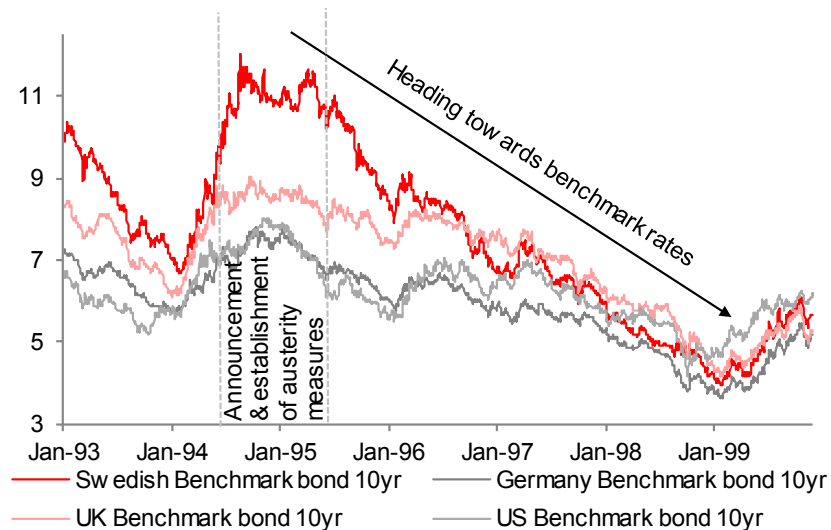
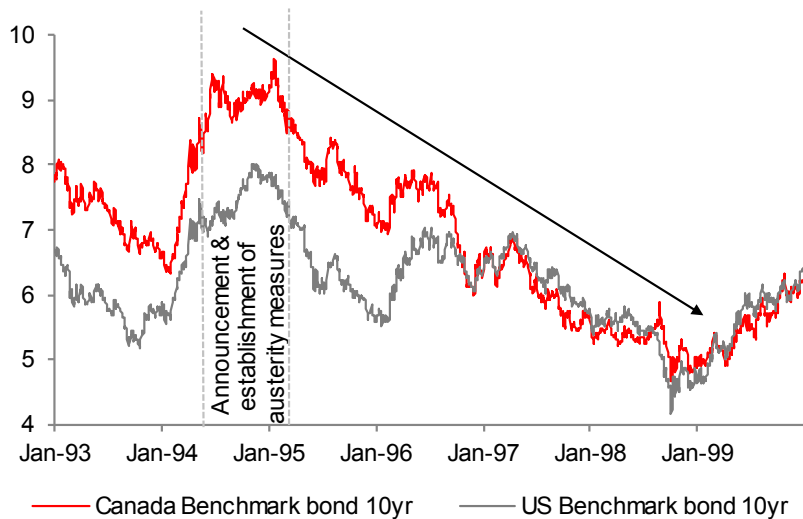
## Examples of successful large fiscal adjustments

Country & period of consolidation	Duration of the plan	General government debt			Structural primary balance			Real GDP growth	Inflation Rate	Interest rates	Unemployment rate
		Start	Peak	End	Swing	Start	End				
		As a percentage of GDP									
	In years							In per cent			
<b>Short duration</b>											
Denmark (1983-86)	3	65	77	72	13.4	-6.4	7.0	3.9	5.4	11.8	6.8
Sweden (1981-87)	6	47	71	62	8.6	-5.7	2.9	2.2	7.6	9.0	3.7
United Kingdom (1994-2000)	6	49	53	45	7.7	-4.4	3.3	3.5	1.8	7.0	7.3
<b>Sweden (1994-2000)</b>	<b>6</b>	<b>78</b>	<b>84</b>	<b>64</b>	<b>11.8</b>	<b>-7.1</b>	<b>4.7</b>	<b>3.7</b>	<b>1.0</b>	<b>6.1</b>	<b>10.1</b>
<b>Long duration</b>											
Western Germany (1980-89)	9	29	41	40	5.2	-3.7	1.5	1.9	2.9	7.8	5.2
Ireland (1980-89)	9	68	114	100	11.8	-7.0	4.8	3.1	9.3	10.5	14.5
Japan (1979-90)	11	41	77	64	7.0	-4.9	2.1	4.6	2.7	6.6	2.4
Italy (1986-97)	11	89	130	130	10.2	-3.4	6.7	2.1	5.0	10.6	10.2
<b>Canada (1986-99)</b>	<b>13</b>	<b>67</b>	<b>102</b>	<b>91</b>	<b>11.1</b>	<b>-5.4</b>	<b>5.7</b>	<b>2.8</b>	<b>2.8</b>	<b>11.1</b>	<b>9.2</b>
Belgium (1984-98)	14	107	141	123	10.3	-3.6	6.7	2.3	2.6	8.3	8.9

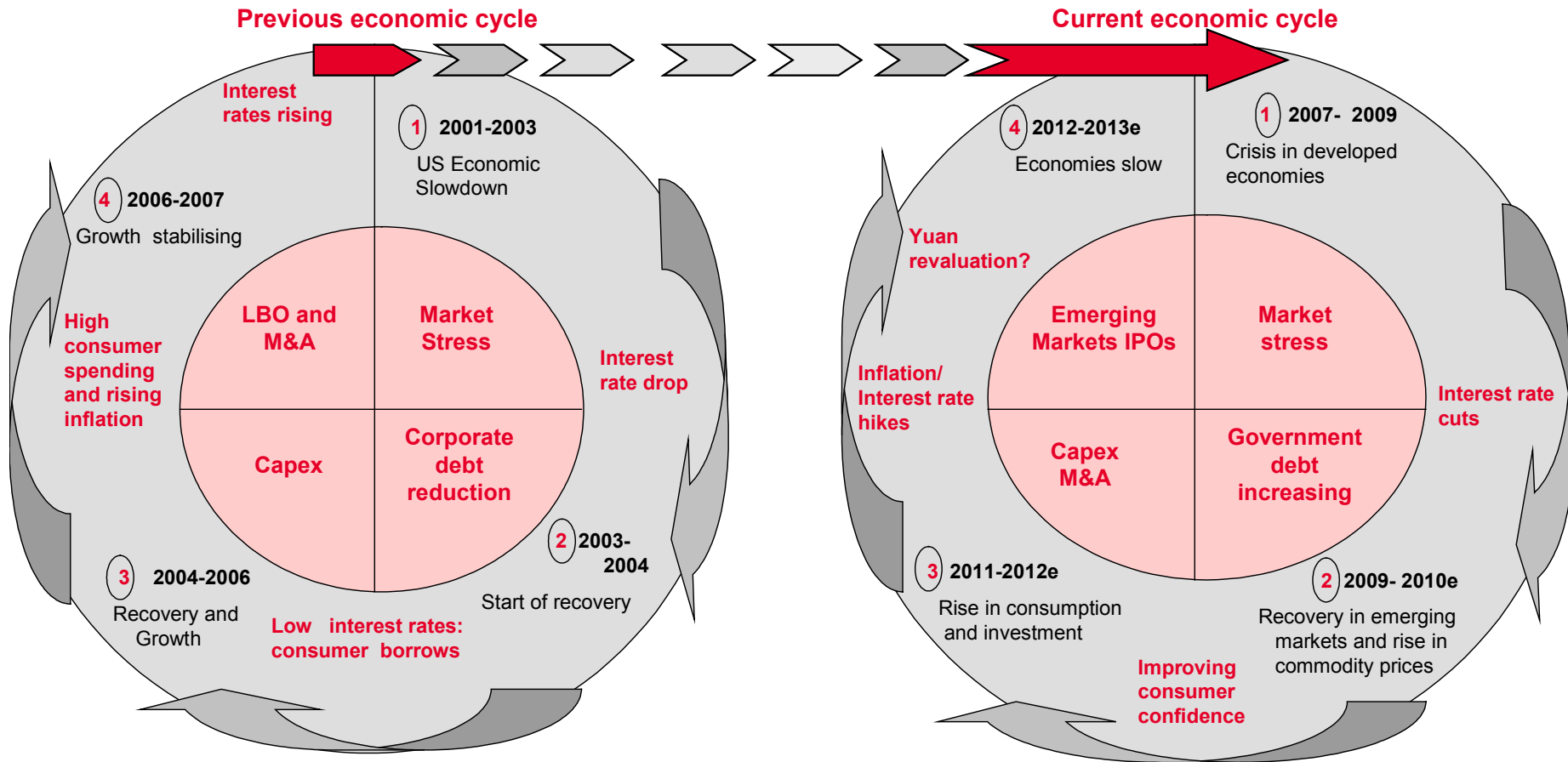
Source: European Commission AMECO database; OECD; BIS; Datastream; national data; SG Cross Asset Research

# First difference: interest rates already very low

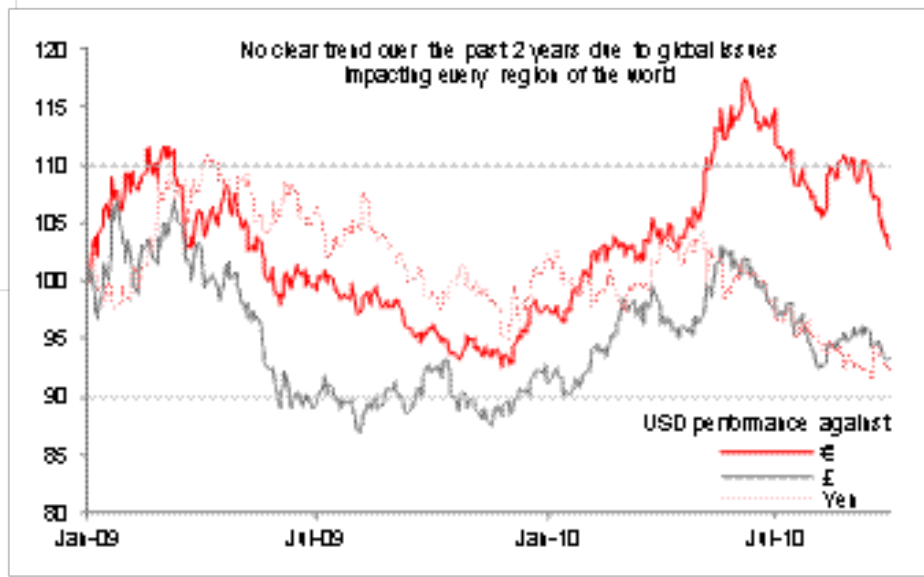
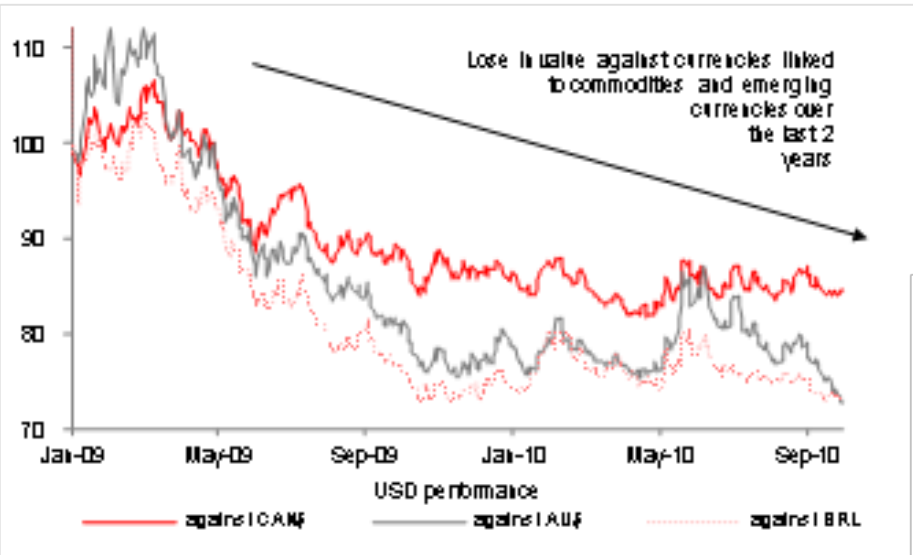
Long-term interest rates: same pattern observed in Canada and Sweden



# Second difference: austerity measures much larger with 21% of global GDP



# Third difference: further depreciation of western currencies takes time to materialize





# All countries cannot win at the same time

## Question 3

Do past examples fully justify these austerity measures?

## Answer 3

*No. Three major differences with the situations observed in Canada and Sweden in the 1990s suggest that not all the austerity plans will be successful and point to a major risk on economic growth if governments implement austerity plans in an uncoordinated manner.*



## Question 4

**Which variable should you look at to analyze the success of these austerity plans?**

*“In matters of style, swim with the current; in matters of principle, stand like a rock”.*  
*Thomas Jefferson*

# Unemployment rate jumped in many countries during the 2009 recession

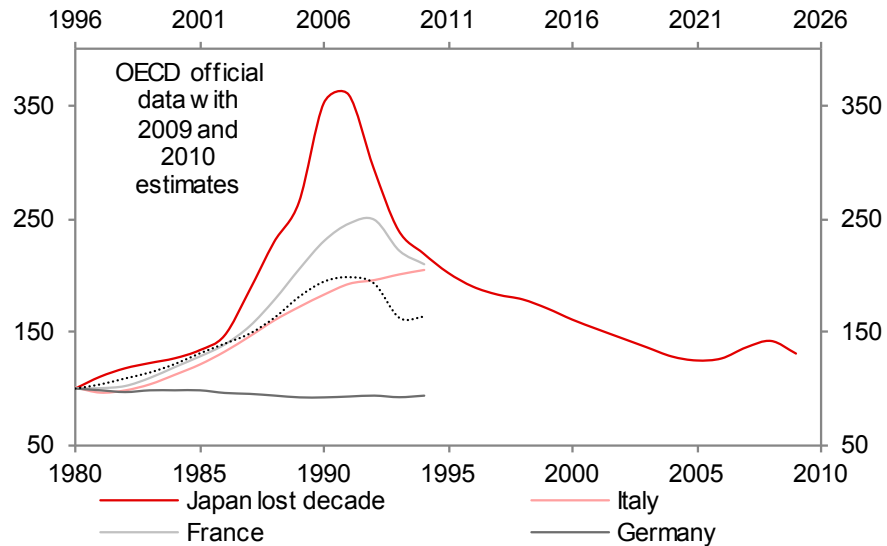
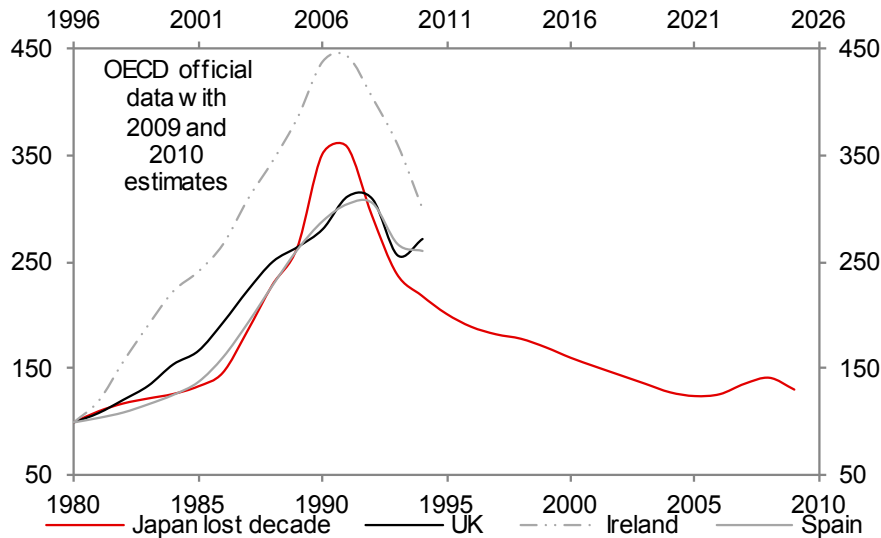
## Unemployment rate in major countries

	2008	2010e	Increase over the recession
Germany	7.40%	8.01%	8.24%
France	7.90%	9.50%	20.25%
Italy	6.80%	8.30%	22.06%
Portugal	7.60%	9.45%	24.34%
Greece	7.60%	9.50%	25.00%
<b>UK</b>	<b>5.20%</b>	<b>7.80%</b>	<b>50.00%</b>
<b>USA</b>	<b>5.80%</b>	<b>9.30%</b>	<b>60.34%</b>
<b>Spain</b>	<b>11.30%</b>	<b>18.20%</b>	<b>61.06%</b>
<b>Ireland</b>	<b>6.10%</b>	<b>12.00%</b>	<b>96.72%</b>

Source: SG Cross Asset Research

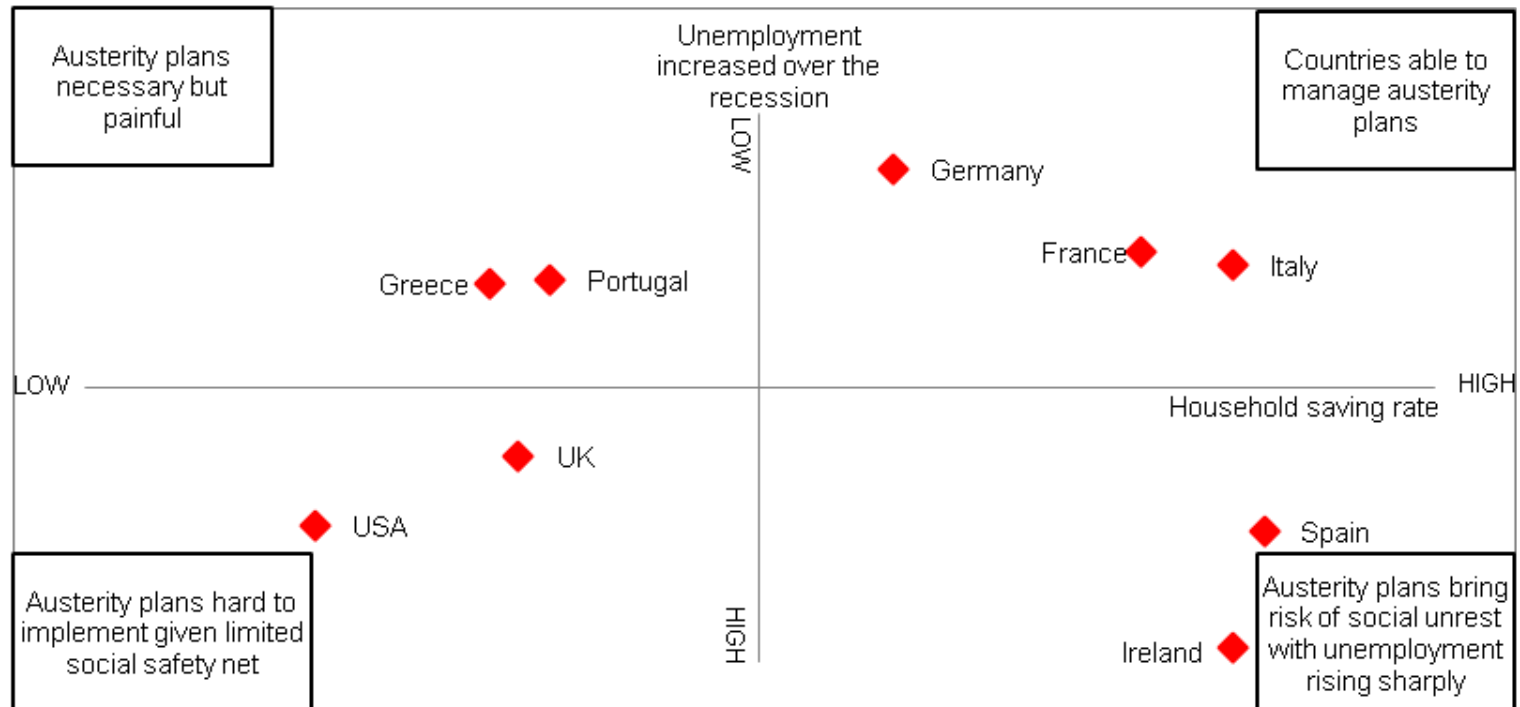
# Property bubble reveals the risk associated to austerity plans

Nominal residential home price



# Unemployment rise and saving rates major variables to analyze the success of austerity plans

## Austerity plans and social risk



# Confidence in the future is essential

## Question 4

Which variable should you look at to analyze the success of these austerity plans?

## Answer 4

*Unemployment trends, saving rates, social movements and property markets are the key variables that can be analysed to forecast the chances of success of the austerity plans. Depending on the country, the austerity plans could be devastating.*



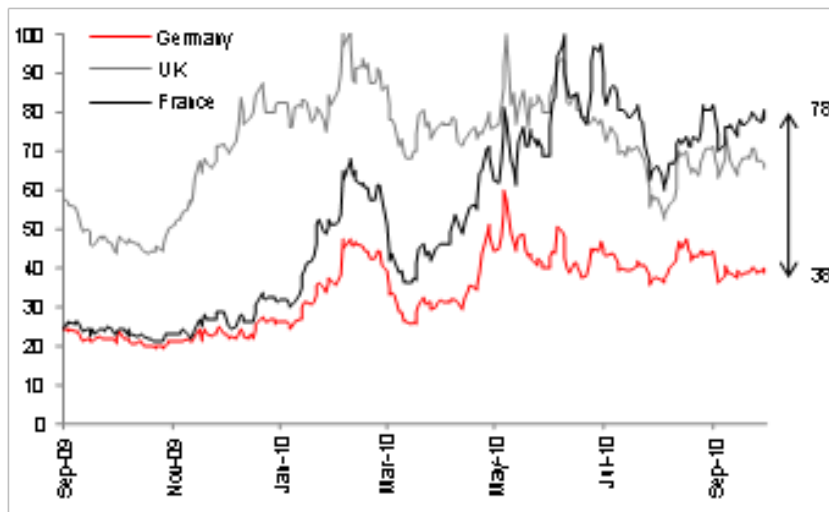
## Question 5

# How to invest under an austerity plan scenario

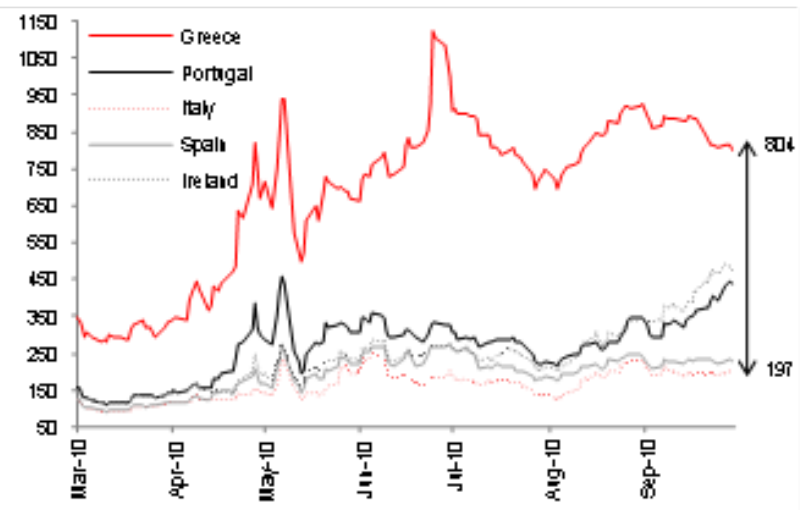
*“You only have to do a very few things right in your life so long as you don’t do too many things wrong”.*  
*Warren Buffett*

# What is discounted by these plan so far

## Successes (bp)



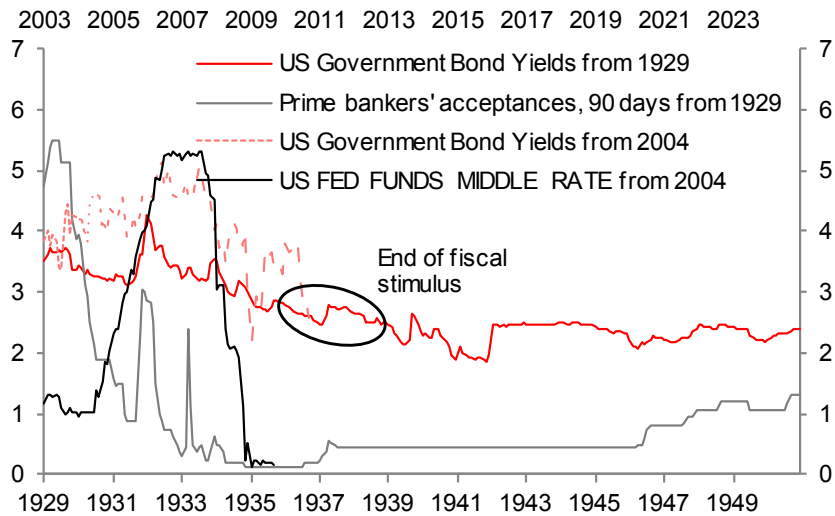
## Failures (bp)



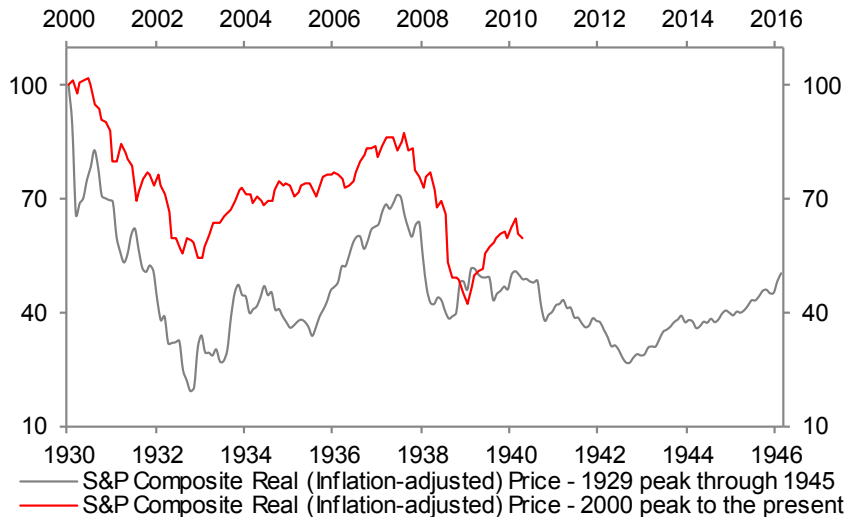


# Worried about inflation? Austerity plans suggest deflation more of a risk for 2011

**Comparing 1929-1950 period with today's US 10YR bond yields**



**Comparing the S&P today and the S&P in the 30s**



# Key recommendations summary

## Recommendations from a European austerity standpoint

Asset class	Impact		
	-	=	+
Fixed income – overall positive	Spain	USA	Portugal
	UK	France	Greece
	Ireland	Germany	Italy
Equities – overall negative	Spain	UK	Portugal
	Ireland	France	Italy
		Germany	
		Greece	
		USA	
Currencies – overall neutral	Expect emerging market currencies to continue to reevaluate		

Source: SG Cross Asset Research

## UK and Spain: risk not priced in

### Question 5

How to invest under an austerity plan scenario

### Answer 5

*Risk-reward is positive for the Greek, Italian and Portuguese bond markets. The execution risks inherent in austerity plans make us more cautious on bond markets in Ireland, Spain and the UK. The UK could benefit from renewed currency depreciation if its austerity measures have an overall negative impact on the economy.*

