

# One Step Forward, Two Steps Back

2011 MAY HAVE BEEN BUMPY BUT 2012 COULD BE EVEN WORSE



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By Persella Ioannides

## 2011

began with an optimistic outlook. Positive GDP growth was expected for the BRICs (7.3%), the US (3.4%) and Europe (1.75%) and generally there was confidence that the global economic recovery would continue. However, fears remained of a worsening euro debt crisis, high US unemployment/deficit, the real estate bubble in China and inflationary pressures in the emerging markets spurred by the quantitative easing (QE) efforts by Western central banks.

In the event, unemployment in the US, albeit still high and worrying, dropped below the 9% threshold. The unavoidable raising of the US debt ceiling led to political deadlock and prompted some market volatility. Yet, an agreement was reached prior to the

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deadline and US 10 year debt, although stripped by S&P of its AAA rating, still trades at historically high levels. In China, evidence of slowing growth and fears of a real estate bubble produced mixed market sentiment. Contraction in GDP growth proved that tightening measures are effective. However, significant growth pressures and concrete signs of a real estate bubble burst have thus far been avoided. In March, Japan, the 3rd largest global economy, was hit by a natural disaster which

destroyed its biggest power plant, wiping out about 3% of its annual GDP and causing global production bottlenecks. Nonetheless, the considerable downturn of 2011 was predominantly a result of the worsening European debt crisis, triggered by the realisation that Greece had not been adhering to the measures imposed by the IMF and the EU in the May 2010 bailout. Market doubts over the success of the implementation of these measures and over Greece's ability to meet future debt obligations, due to higher financing costs, led to further turmoil. The political delay by EU leaders to introduce a sufficient aid package led to a contagion effect on the debt of other countries such as Spain, but, more importantly, Italy whose 10 year debt yields rose above the 7% barrier: a bailout alert, as it is the level reached by Greece, Ireland and Portugal before they were placed on support mechanisms. The ECB began buying Italian debt to

push yields below 7% but stated that it would not do so indefinitely. Market volatility remains as the EU bailout funds via the €440 billion EFSF and, now, the €500 billion ESM, are not sufficient to bail out Italy, the world's 8th largest economy and 3rd largest debt market; In 2012, Italy alone has debt obligations of €364 billion while one third of the EFSF must refinance most of Greece's second aid package.

The markets had been hoping that the December 10 EU summit, which led to the much-anticipated fiscal pact, by which automatic sanctions will be applied on future budget rule-breakers, would alter the stance of the ECB, especially as the pact was backed by Germany among 26 EU member states. However, the outcome was deemed to have a gradualist as opposed to an immediate, comprehensive solution and that this would continue to add volatility and be costly to the markets. Moreover, the cautious stance of the ECB remained and left the rating agencies dissatisfied, inciting further downgrades and placements of sovereign debt on negative outlooks.

## 2012

The outlook for 2012 is grim and complicated. The strict austerity measures imposed on high deficit eurozone countries have had a damaging effect on growth which, without caution, could steer the eurozone into deep recession. The markets perceive the bailout schemes that the political leaders have drafted to date, as deeply unresponsive of requirements. The two acceptable solutions for the eurozone are arguably either the introduction of Eurobonds or the ECB acting as a 'lender of last resort' to banks which would, in turn, purchase sovereign debt. The former is doubtful as northern countries do not want their financing rates to increase or to carry the debt burden of peripheral countries. The latter, on the other hand, requires that the ECB change its mandate, a move that would require EU

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consensus. However, it is possible that with any worsening of the situation, German intransigence will be forced to subside and the ECB will be permitted to act as a 'lender of last resort', a role akin to that of the Federal Reserve in the US and the Bank of England in the UK. The banking situation remains troublesome as the dollar interbank lending rate has been frozen. Additionally, European banks are undertaking valuable asset sales to strengthen their balance sheets and reach a core tier 1 ratio of 9% amid a capital shortfall of €115 billion. They remain heavily susceptible to the crisis through their sovereign debt and direct market exposure to struggling peripheral economies. Global banks are also exposed through CDS insurance sold to their European counterparts as protection against European sovereign debt defaults.

We remain hopeful that although the economic situation may continue to worsen, a long-awaited bold move will emerge to circumvent a critical event such as a major government default or the breakup of the eurozone. It is not in the interest of the eurozone or the rest of the Western world for the situation to deteriorate. The ECB has, for the first time, already made available 3-year loans to banks. Although banks seem reluctant to invest further in sovereign debt and insinuate that they will instead lend to the real economy, it is a step in the right direction. We anticipate a partial nationalisation of some ailing banks, similar to the TARP programme implemented during the sub-prime crisis. Expectations are for Europe to contract to 0.5% GDP from 1.4% in 2011, the US to exhibit moderate growth of 2.5% from 2.7% in 2011, with the Fed ready to fuel QE3 if threatened by euro debt or other crises. The BRICs, a predominant contributor to global growth, to grow 6% in 2012, roughly at 2011 rates; China's growth is

expected to fall to 8.5% from 9.3% last year, mainly on lower exports through weakening global demand. Russia, India and Brazil also experienced contracting GDPs in 2011, also due to waning global demand and contracting monetary policies to stave off respective inflationary pressures. In 2012 growth is anticipated to be equivalent to that of 2011 at 5%, 7% and 3.5% respectively.

Cyprus is also caught deep in the euro debt crisis. The domestic commercial banks' assets, at 5 times (€92 billion) the country's GDP, are heavily exposed to Greece both through their bond portfolios and loan books. The former are at relatively manageable levels but, with an anticipated economic deterioration in Greece, the latter are worrisome. Thus we foresee government intervention of varying degrees in Cyprus's largest banks. Raising the required estimate of €3.6 billion from the market to increase the core Tier 1 ratio and to provide a buffer versus further losses on Greek and other peripheral sovereign debt will prove difficult in this illiquid credit market.

Through a partial nationalisation of the banks, the confidence of Russian and other foreign depositors in our banking system should recover. If the upcoming elections in Russia maintain a stable political climate, the financial services sector, now the driving force of the Cypriot economy, should, if all else remains equal, continue to prosper. Consequently the banks will survive and related industries, such as law firms and professional services organisations, will continue to develop.

The political leaders of the eurozone need to recognise the magnitude of the threat of the current crisis and its high correlation with the global economy. Ben Bernanke and co. may be congratulating themselves on how lessons of the 1930s Great Depression enabled an exit from the sub-prime crisis and a prevention of a double dip recession. However, it is widely believed that a key cause to the depression that occurred within the recession of the 1930s was the tight fiscal policy that stemmed all growth.

We need to beware because the current situation in the eurozone looks eerily similar. **G**

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