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Market Insights



Karen Dunn Kelley
Senior Managing Director, Investments,
Invesco Ltd.



John Greenwood
Chief Economist,
Invesco Ltd.

Assessing the state of the union

Year 2012 will be critical for the European Union (EU) - and for the world economy - as leaders strive for financial and political solutions to the debt crisis that has continually plagued the region since 2009. The difficulties in reaching credible solutions - and the market turmoil that results from such uncertainty - have been on full display in December.

European leaders gathered for a two-day summit in Brussels in early December and agreed to a two-pronged crisis-management approach, prompting a stock rally in the US and Europe. However, just days later, on 19 December, EU finance ministers announced they had not reached their goal to raise EUR200 billion in loan resources for the region. Amid this news, stock markets plunged - briefly. The next day, 20 December, global markets rallied on the back of a positive Spanish bond auction, a better-than-expected German business confidence survey and an increase in US housing starts.

In the face of such ongoing volatility, perspective is needed. As such, Invesco Senior Managing Director Karen Dunn Kelley has asked Invesco Chief Economist John Greenwood to share some of his thoughts on the eurozone crisis and provide his views on what he believes we might expect in 2012. John is based in London and, therefore, has a bird's-eye view of the unfolding events.

Q: John, can you briefly describe the two-pronged plan that was agreed to at this month's crisis summit?

A: First, the leaders committed their countries to a greater measure of fiscal discipline than in the past by agreeing to pass constitutional amendments in each country maximizing structural budget deficits of 0.5% of gross domestic product. This new 'fiscal compact' is to be achieved according to individual member state timetables proposed by the European Commission, and ultimately subject to the jurisdiction of the European Court of Justice.

Second, the leaders agreed to boost the so-called stabilization tools. In a nutshell, this means they have agreed to use the European Financial Stability Facility, which was set up to provide financial aid to ailing member states. In addition, the creation of the permanent rescue fund - the European Stability Mechanism - has been brought forward to July 2012. The combined lending capacity of the two institutions is to be limited to EUR500 billion, and the members would subscribe EUR200 billion to the International Monetary Fund (IMF) for use in bilateral loans, that is, a loan between one lender and one borrower.

Q: All EU member states have agreed to this plan, except the UK to date, the UK has also declined to contribute to the IMF loan fund, which currently remains EUR50 billion short of the EUR200 billion goal. What is your take on the UK position?

A: In my opinion, the UK has used their right as a member of the EU to veto this proposal. When considering whether this was a good move on the part of UK Prime Minister David Cameron, it is important to remember that the UK is not a member of the eurozone. It is therefore hard to see why the UK should accept compromises to their national sovereignty in the form of financial sector regulation, when the whole purpose behind the fiscal compact is to both impose discipline on and rescue weaker members of the euro-currency union.

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Q: Do you believe the two-pronged approach agreed at the Brussels summit is enough to stem the crisis?

A: No. The latest plan may help to avoid the next crisis, but it is not sufficient to solve the current one. Despite the liquidity measures agreed on - a reserve ratio cut, the provision of three-year refinancing and the expansion of eligible collateral - it is by no means understood that these measures will be adequate. Banks and sovereigns in the euro-area have their hands tied: if sovereigns default, banks could face runs, higher financing costs and the need for capital infusions - yet if private markets refuse to recapitalize impaired banks, only sovereigns with no fund raising power remain.

The financial markets need a far more concrete plan, implemented with a higher degree of urgency and fiscal requirement. Markets are distrustful, remembering the previously attempted Stability and Growth Pact that was ignored, chiefly by Germany and France in 2003 and 2004 when each refused to pay the penalties incurred.

Q: What do you believe is missing from the plan?

A: Three key elements are missing. The plan contains no final end game, no proposal of how to revive growth, and no attempt to address the specific loss of competitiveness in southern Europe. Instead, it focuses on resolving the crisis through internal adjustment by the debtors, rather than requiring adjustments by creditors and debtors.

Lastly, instead of limiting the combined rescue funds at EUR500 billion, I believe the leaders should have capped it much higher, and made the funds available immediately.

Q: What does that mean for 2012?

A: In my view, the eurozone debt crisis will persist through 2012 and beyond, exacerbated by the deepening recession among the heavily indebted southern eurozone members. Among the major currencies, the euro is beginning to lose its appeal, and I believe it will decline further against the US dollar, the Japanese yen and the British pound, bringing more crisis to the crisis.

Q: Sounds like 2012 will be a challenge for investors. Where do you see opportunities?

A: I believe the emphasis should still be on quality assets that generate sustainable yields, such as corporate and high-yield bonds in the fixed income area; 'bond-like' equities; and real estate funds that offer the potential for strong and stable flows of rental income.

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