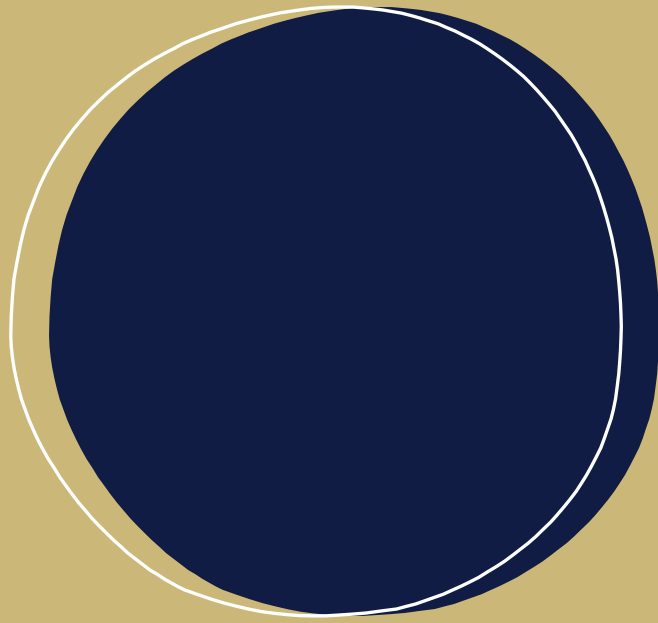


News from the financial markets

Can the euro zone manage to reduce debt?

April 8, 2010





Can the euro zone manage to reduce debt?

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Traditionally, government bonds have been viewed as a conservative core holding in a balanced investment portfolio. Is that status still justified today, given the high level of government indebtedness?

Yes. Spending cuts of a reasonable magnitude and moderate nominal economic growth as of 2012 should make it possible for many of the EU member states to meet the Maastricht deficit criterion by 2015. Debt ratios should then stabilize at the newly achieved levels. To accomplish that, it is not even necessary for the states to generate a budget surplus.

Over the same time frame, a debt reduction to a maximum of 90% of GDP is entirely conceivable but would require very painful public spending cuts in many countries.

In the meantime, bondholder skepticism can lead to high risk premiums on the debt of some issuers. Because interest costs can rapidly get out of control as a result, a renewed surge of speculation on the solvency of certain countries cannot be ruled out. **We expect falling prices in the medium term and remain significantly underweight in our mandates.**

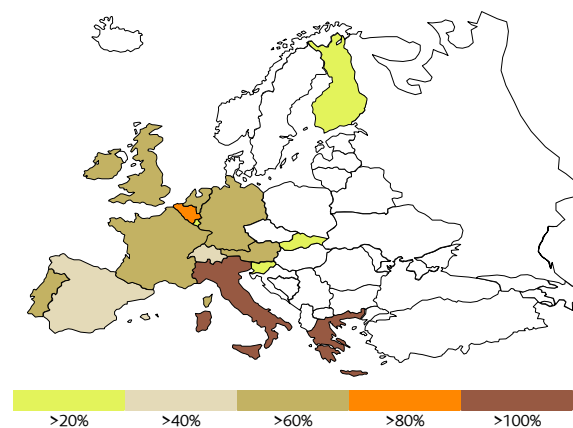
Although public cost-cutting measures are unavoidable, it is important that they not be too aggressive. The economic rebound is moderate at best; any exaggerated efforts to achieve savings would pose a threat to further economic recovery.

High deficits are a result of the crisis

Combating the financial and economic crisis has caused the budget deficits of most EU states to soar. Bank rescues, stimulus packages, as well as measures to ease unemployment and create jobs lead to higher government expenditures, even as revenues from personal and corporate income taxes dwindle in the wake of the recession.

Annually recurring, excessive budget deficits spawn a persistent spiral in government indebtedness. Risks increase and thus interest costs as well, and that burdens the budgets even more in the following year. In Greece, interest payments on the national debt alone already amount to roughly 4.5 percent of the country's gross domestic product (GDP); in Italy, that sum lies just shy of 5 percent. And any increase in base lending rates would exacerbate this vicious cycle even more in the years to come.

Current debt ratios (euro zone, Switzerland, UK)



Source: VP Bank, Bloomberg

Consolidation is unavoidable

Markets and investors are taking a very negative view of today's burgeoning national debt levels. Some players are frightened by the waning credibility of government borrowers, whose new bond issues represent an important anchor for the international financial markets and serve as key instrument for implementing central bank monetary policy; others foresee higher taxes and imposts or soaring inflation. The byproduct of all this: higher risk premiums. Consequently, the refinancing of maturing bonds

and arranging for new credits is becoming progressively more expensive for certain borrowers.

Impaired trust leads to higher risk premiums



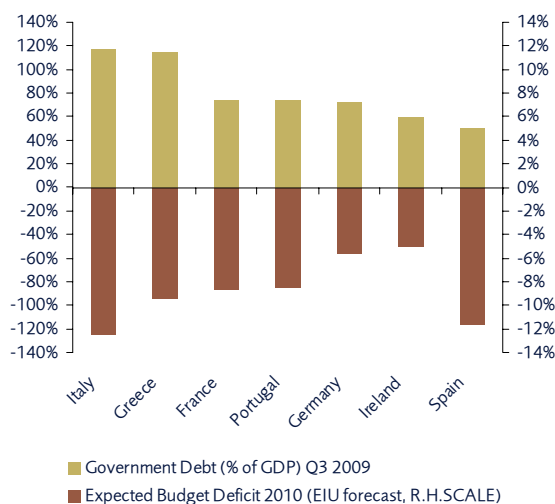
Source: VP Bank, Datastream

Thus the minimum goal for governments must be to stabilize their national debt ratios in order to regain the trust of investors and taxpayers, as well as to keep their interest costs under control. Debt reduction is of course desirable, but in many countries it would require additional and in part unrealistic savings efforts. Moreover, any such attempt would threaten the still wobbly recovery.

EU stipulations lead to stabilization

The European Commission is demanding a speedy return to the deficit parameters of the Maastricht Stability and Growth Pact, i.e. new government debt of a maximum of 3 percent of GDP. But the second Maastricht criterion – a debt ratio not higher than 60 percent of gross national product – remains beyond the reach of many European states for the time being. For almost two-thirds of the member nations, public indebtedness currently lies far in excess of that threshold value.

Government debt ratios and anticipated budget deficits



Source: VP Bank, Datastream, Economist Intelligence Unit

Already prior to the crisis, the European Commission had called on numerous governments to introduce savings measures because their debt ratios were out of line. But in the past, its recommendations rarely had any binding force. So too many states merely ignored them. These days, however, the market is seeing to greater discipline in this regard. And as a result of the coordinated rescue operation for Greece, the authority of EU institutions has also increased.

Debt stabilization is entirely possible

A stabilization of debt ratios – although at very differing levels – is possible for most EU states if they can keep their net new indebtedness as of 2015 at the prescribed Maastricht level. The preconditions for accomplishing that:

- the budget deficit is steadily reduced in the coming years in order to once again meet the Maastricht criterion (3 percent net new debt);
- the European economies show hardly any growth in 2010 and 2011 (or even remain mired in recession), but as of 2012 expand continually by roughly 2% per year;
- consumer prices remain stable during the same time frame (ca. 2% inflation p.a.).

In this scenario, the increase in debt (by a maximum of 3% of GDP) as of 2015 is smaller than the nominal GDP growth rate (4%). Thus the debt ratio starts to decline at latest as of 2015. In Greece, Italy and Portugal, the debt ratios would begin to ease even before 2015 (see country analyses in the appendix).

Cost-cutting packages are the key to success

However, this thoroughly positive development would necessitate varying degrees of effort on the part of governments to get their households tidied up in the next several years. **For example, Germany, Italy and the Benelux countries could maintain their debt ratios at constant levels as of 2015 by introducing annual savings of less than one percent of GDP. Greece, Great Britain, Ireland and Spain on the other hand need to make cuts equivalent to approximately 2 percent of their GDP to achieve the same goal.** That of course is very ambitious, especially if rising interest rates heighten the interest costs during the same time frame.

	Government Debt (% of GDP)		Required annual savings (to achieve a budget deficit of 3% in 2015)
	2009	2015	
Italy	117%	115%	0.5%
Greece	114%	122%	1.9%
Portugal	74%	94%	1.1%
Germany	72%	81%	0.5%
UK	64%	100%	2.1%
Ireland	62%	91%	1.9%
Spain	50%	82%	1.7%
Switzerland	44%	45%	-0.3%

Source: VP Bank; Datastream, Bloomberg

Debt reduction is largely unrealistic

A return to greater fiscal discipline does not automatically reduce the debt ratios. Rather, national indebtedness will level out at widely differing readings. In 2015, four of the analyzed countries will still carry debt that is clearly higher than 90% of GDP (in the current discussions, that number is progressively becoming the "benchmark" because, in the past, readings above that level have put a heavy damper on economic growth – and consequently, the vulnerability to crisis increases dramatically; see Reinhart and Rogoff, 2009, Growth in a Time of Debt).

A return to levels below 90% will hardly be achievable by 2015 especially in Greece. Only Germany and Spain are in a position to meet that goal by means of reasonable consolidation measures.

	Required annual savings	
	(to achieve a budget deficit of 3% in 2015)	(to achieve a government debt ratio of 90% in 2015)
Italy	0.5%	2.2%
Greece	1.9%	5.4%
Portugal	1.1%	1.5%
Germany	0.5%	0.0%
UK	2.1%	2.5%
Ireland	1.9%	2.2%
Spain	1.7%	1.2%
Switzerland	-0.3%	-3.2%

Source: VP Bank

So the risks vary. Core euro zone states such as Germany could master the challenge handily in the next several years. But for others, it will be more difficult; they simply need more time.

On the whole, however, government bonds remain an important core portfolio holding in both scenarios. Not least of all thanks to their correlation characteristics, they represent a low-risk counterbalance to the more risky asset classes.

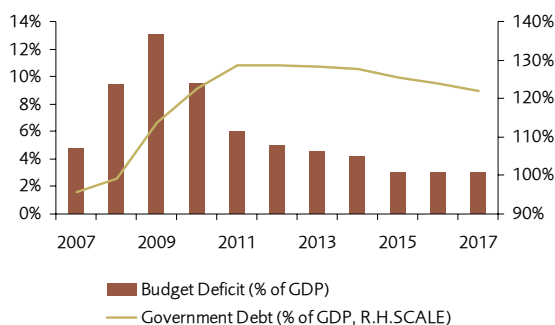
The bottom line:

Many EU states have justifiably shouldered the costs of the crisis in order to cushion the effects of the global recession. However, they are now faced with the daunting challenge of getting their fiscal households back in order. The overextended situation that existed in several countries already prior to the crisis has led to sporadic financing bottlenecks and triggered an increase in borrowing costs. That in turn heightens the pressure on governments to consolidate their debt. Nonetheless, a stabilization of debt ratios in many countries is indeed possible under realistic circumstances; others will have to make much greater efforts. Achieving more ambitious debt-reduction goals would require what in part are unrealistic budget adjustments. Moreover, any such moves would unduly burden the overall economic recovery. In terms of fixed income investments, top-rated corporate bonds are the current beneficiaries of this uncertainty surrounding government indebtedness. In the medium term, we expect falling prices for most government bonds.

Appendix: individual country analyses

Greece: The Greek government has already approved cost-cutting measures in the amount of 4 percent of GDP for 2010. The steps include salary reduction for public administrators, an increase of two years in the average retirement age, as well as a hike in value-added and mineral oil taxes. The government's goal of pushing the deficit below the prescribed 3% mark by 2012 is indeed ambitious.

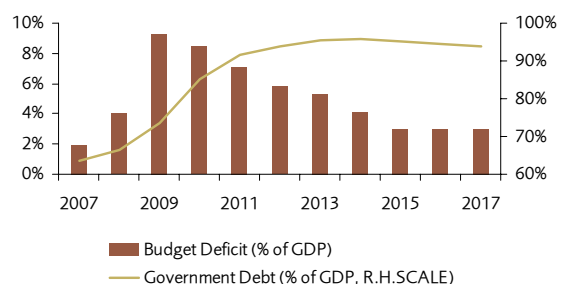
Greece: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Portugal: Two weeks ago, Fitch reduced its credit rating for Portugal to AA- with a negative outlook. The country's indebtedness currently stands at roughly 75% of GDP. In order to reduce the anticipated budget deficit of 8.5%, the government has initiated a four-year austerity program similar to the Greek package. In addition, a privatization program should generate income for the state equivalent to 3.6% of GDP. Nevertheless, the markets reacted nervously to the downgrade.

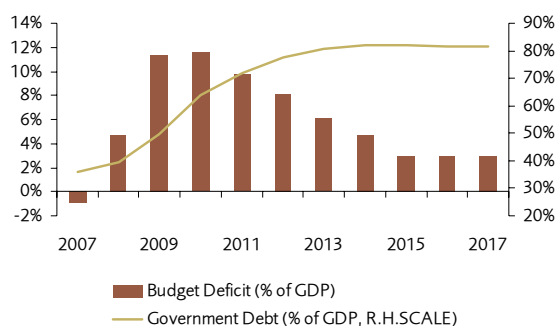
Portugal: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Spain: Spain has no desire to be punished by the markets the way Greece and Portugal have been, thus it has already introduced a drastic cost-cutting program. Although its debt ratio of roughly 50% is still comparatively modest, the country's anticipated 2010 budget deficit of just under 12% of GDP will nevertheless trigger a rapid increase in that reading. Also in Spain, salary cuts for public servants as well as hikes in the retirement age and VAT should bring the budget deficit down to a level below the Maastricht limit already by 2013.

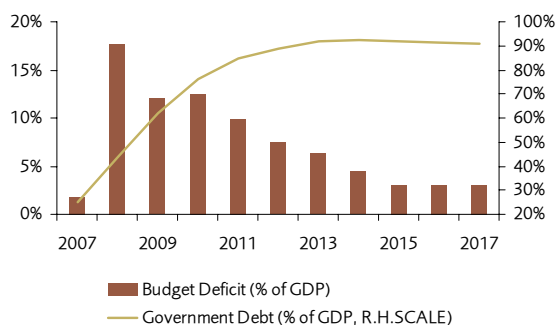
Spain: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Ireland: Previously, the "Celtic tiger" could regularly reckon with high GDP growth rates. But in the wake of the financial crisis, the credit and real estate bubbles on the Emerald Isle burst and dragged the economy into a severe crisis. Enormous expenditures for bank rescues and the jobless, coupled with sinking tax revenues, caused the country's debt ratio to increase from 25% of GDP to 60% within the space of just two years. For 2010, yet another budget deficit is forecasted in the amount of 13% of GDP. Through salary cuts, higher income taxes and an environmental tax on gasoline, the government hopes to save close to EUR 4 billion annually (at present, ca. 2.5% of GDP).

Ireland: VP Bank scenario

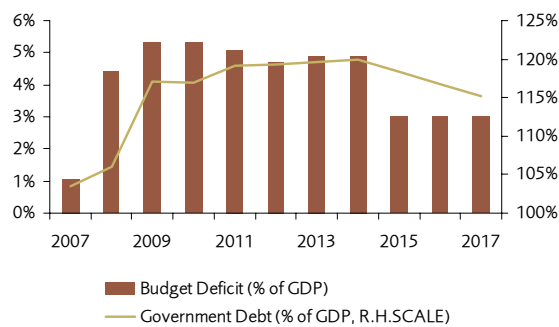


Source: VP Bank, Datastream, Economist Intelligence Unit

Italy: With a debt ratio of 117%, Italy heads up the inglorious list of Europe's destitute states. But at roughly 5%, the budget deficit for the current

year is likely to lie just marginally above the Maastricht criterion. As a result, the Italian government has yet to announce an austerity program. Nonetheless, a consolidation is called for also on the southside of the Alps, given the country's heavy debt load.

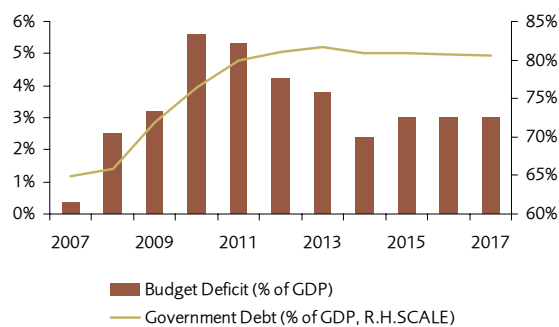
Italy: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Germany: At a level slightly above 70%, Germany's debt ratio also exceeds the stipulations of the Maastricht Stability and Growth Pact. The planned net new indebtedness of 5.6% breaches the EU guidelines as well. By 2013 (according to the Federal Finance Minister), the budget deficit should be back below the 3% mark. However, no concrete measures have been adopted to date.

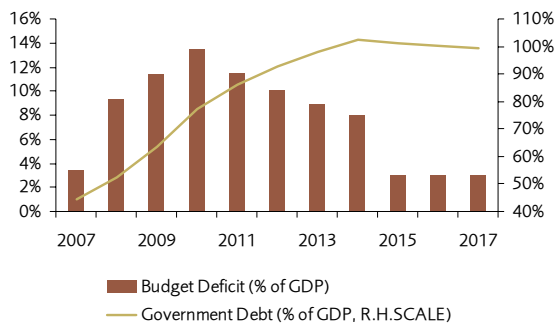
Germany: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Great Britain: The discussion surrounding government indebtedness in the euro zone has also reached the British Isles. The markets are starting to focus more sharply on Britain's debt situation. Interventions aimed at combating the crisis have caused a dramatic increase in government debt: at present, the ratio stands at roughly 65%. The forecasted budget deficits for 2010 and 2011 (ca. 12% each year) will result in a further rapid increase in national indebtedness. The AAA rating for Great Britain is no longer secure, and that could put heavy pressure on yields. The pound has already depreciated considerably.

Great Britain: VP Bank scenario



Source: VP Bank, Datastream, Economist Intelligence Unit

Due to elections, the current government is unlikely before summer to take any unusual steps in the direction of budget consolidation. Moreover, any hasty move to cut costs would jeopardize the still tentative recovery. However, the goal of the government is to reduce the deficit to 4% over the next five years. That will involve the toughest savings measures in recent decades. Precise details in this regard are not yet known.

Switzerland is not familiar with this particular issue

National debt is not a topic of discussion in Switzerland. Thanks to the country's buoyant economy, its debt ratio declined markedly from 60 to 44 percent between 2004 and 2008. Because economic measures in Switzerland have focused on monetary policy, the ratio increased only marginally to the current 45 percent level even in

the throes of the crisis. The forecasted budget deficit of 0.5% of GDP for 2010 has therefore already contributed significantly to the stabilization of Switzerland's debt ratio.

How do things stand with the USA and Japan?

Government indebtedness is also a front-burner topic outside of Europe. America's debt ratio stands at more than 80%; in Japan, the figure is roughly 180%.

At present, the US is making to major effort to reduce its budget deficit. Again this year, that shortfall will amount to at least 10% of GDP and the debt ratio will soon be pressured above the 100% mark.

We are looking for tax hikes and/or cost-cutting measures to be introduced, but not before the Congressional elections in November. America can still refinance itself at favorable costs. The demand for Treasury paper remains strong. Japan also enjoys lost-cost refinancing conditions. Due to persistent deflationary tendencies, yen-based interest rates have hovered around the zero level for more than ten years now. The high household savings rate, combined with investors' trust in Japanese bonds, permits this ostensibly enormous debt ratio of 180%. But crisis countermeasures and declining tax revenues have also taken their toll on Japan's budget: in 2010, the deficit can be expected to hit approximately 8% of GDP after having been less than 3% just two years ago.

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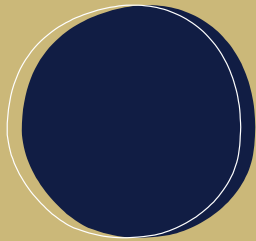
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