Government Actuary's Department

# Investment News

## Monthly Bulletin from the Insurance & Investment Team

March 2017

## Last Month in Brief

Latest figures from the Office for National Statistics (ONS) showed the UK's consumer price inflation rate reached 1.8%, the highest rate in two and a half years. This increase was in part due to rising energy prices and the impact of the weakened pound. This was below economists' predictions of 1.9% but still within reach of the Bank of England's target of 2%. Since the Brexit vote in June, the UK's economy has performed better than expected with consumer spending and growth in the services sector higher than initially expected. However, economists have cautioned higher levels of inflation could slow growth as higher prices discourage consumer spending.

New data released by Eurostat, the European Commission's statistics bureau, reports that the Eurozone's economy grew by 0.5% in the last quarter of 2016, despite the political uncertainty around Brexit and the US election of Donald Trump. This has brought growth in the Eurozone to 1.8% since the end of 2015. Inflation rates in the Eurozone rose to 1.8%, which was largely driven by an 8.1% increase in energy prices compared to the previous year.

The Lord Chancellor announced that the personal injury discount rate, known as the Ogden rate, which is used to calculate personal injury pay-outs, would be cut for the first time since 2001 from 2.5% to -0.75% (relative to RPI). The reduction reflects a significant fall in inflation-linked government bond yields since 2001. The size of the reduction was not anticipated by the insurance industry and caused the share prices of motor insurance firms to fall as the market reacted to the news. The reduction will increase the amount that insurers have to pay to claimants. As a result of this, the premiums paid by consumers will likely increase as insurers pass on the extra costs to consumers.

Chart 1: Equity Indices
Equity returns increased during the month

Chart 2: Sterling Credit Spreads
*Credit spreads were stable over the month*

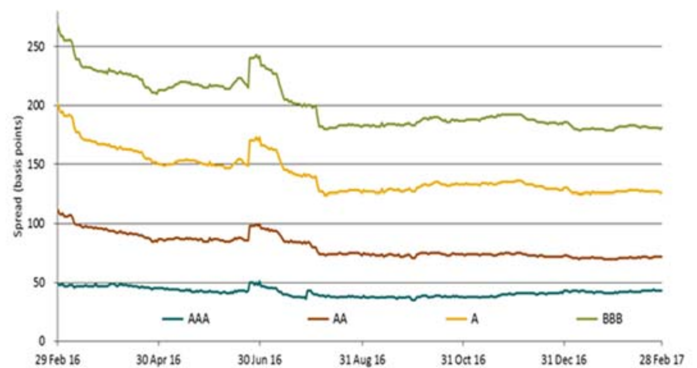



Chart 3: Gilt Yields
Nominal gilt yields fell over the month

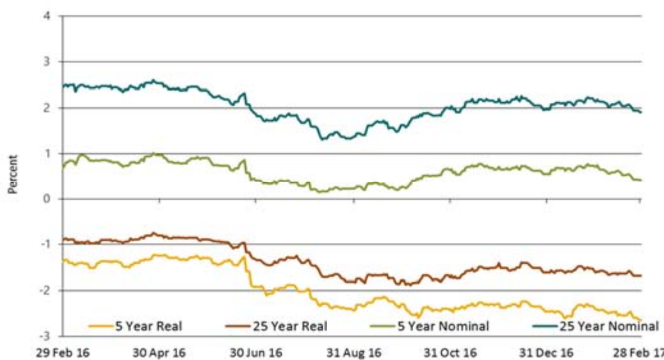
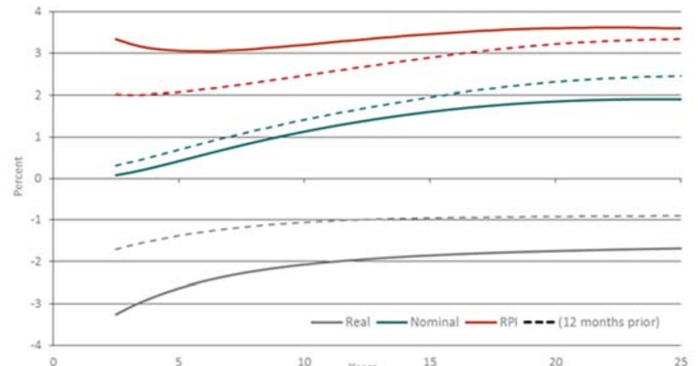



Chart 4: Gilt Spot Curves
The yield curve remains upward sloping




Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

| | Latest | Previous | | Latest | Previous |
|---|---|---|---|---|---|
| **CPI increase (annual change)** | 1.8% | 1.6% | **Base rate** | 0.25% | 0.25% |
| **PPF 7800 funding ratio** | 88.2% | 86.8% | **$/£ exchange rate** | 1.24 | 1.26 |
| **Halifax house prices (monthly change)** | -0.9% | 1.7% | **VIX (volatility) index** | 12.92 | 11.99 |

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

# An update on European sovereign debt

Almost a decade on from the European sovereign debt crisis, assistance towards the recovery of these member states' economies remains a contentious issue between leading European nations and the International Monetary Fund (IMF). Both sides continue to argue over the stringency of covenants that should be imposed upon countries and in particular Greece.

The crisis began in 2008 following the collapse of Iceland's banking system. The crisis spread throughout the Eurozone with certain member states known as PIIGS unable to bail-out their financial institutions and repay high government debt.

## Who are PIIGS countries?

PIIGS is an unofficial acronym that refers to the five Eurozone nations of Portugal, Italy, Ireland, Greece and Spain. It was created by currency traders and global investors due to the instability of these economies following the financial crisis in 2008.

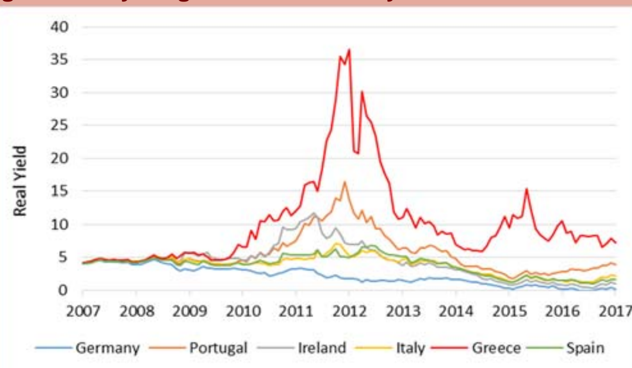
## What happened to PIIGS during the crisis?

The currency union structure in the Eurozone meant PIIGS were unable to use independent monetary policy to help recover from the downturn. Consequently, techniques aimed at lowering interest rates and increasing money supply were unavailable.

This resulted in key credit rating agencies lowering the credit ratings on the respective countries' government debt. This downgrade lowered investor confidence with the rating change signalling an increased likelihood of default.

Figure 1 below shows the divergence between the 10 year government bond yields for PIIGS compared with Germany. A significant proportion of this is due to the higher return required by investors to compensate the increased likelihood of PIIGS' defaulting with factors such as inflation making up the residual difference. This divergence peaked in 2011 due to political instability and Greece's debt being downgraded to junk status.

**Figure 1: 10 year government bond yields**




**Data Source: https://www.investing.com**

## How did the Eurozone respond?

As concerns intensified that the debt crisis could cause the collapse of the euro and financial contagion, leading European nations and the IMF introduced a series of financial guarantees to support PIIGS' economies. They approved a €750 billion package in 2010 to help the nations recover from the crisis.

For Greece in particular, the risk of default led to the EU and IMF paying out €240 billion in emergency funds to keep the banks capitalised.

## Current situation in Greece

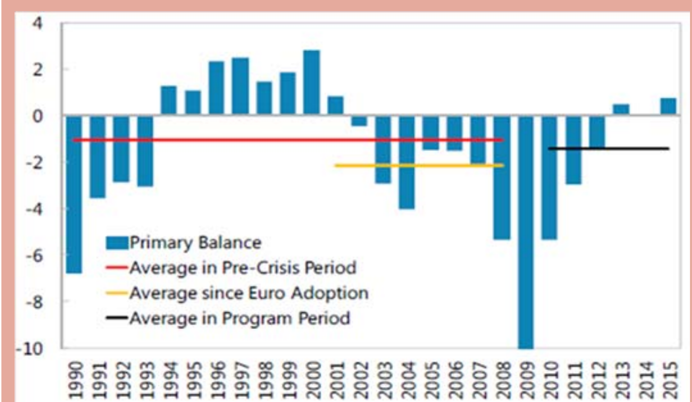
The outlook for the majority of PIIGS is more positive than it was previously, however Greece remains volatile. Negotiations between Greece and its creditors on how to review its €86 billion bailout have slowed, and a debt repayment of €7.4 billion is due in July 2017.

The IMF argues Greece will not be able to achieve its fiscal goal of a primary balance of 3.5% GDP from 2018 without cuts from pensions and the tax free threshold on personal incomes. The primary balance is the government net borrowing excluding interest payments on consolidated government liabilities as a percentage of GDP.

Figure 2 below shows the historic primary balance for Greece, highlighting Greece has averaged a negative primary balance both before the debt crisis and since the debt program was introduced.

The IMF have proposed lowering the primary balance to 1.5% of GDP with Eurozone countries accounting for the difference through substantial debt relief.

**Figure 2: Greece: Primary Balance (% of GDP)**




**Data Source: IMF Report– Greece: Preliminary Debt Sustainability Analysis-Updated Estimates and Further Considerations / WEO (May 2016)**

## How do the Eurozone countries view the IMF's proposal?

EU countries such as France and Germany have challenged the recent IMF forecast for Greece as too pessimistic and have openly stated that they are unwilling to meet the IMF's demands.

The IMF has not participated in a bailout loan in three years and has stated it will maintain this position without significant changes. Germany's finance minster, Wolfgang Schäuble, has argued without the IMF any support for Greece is unsustainable. Prolonged uncertainty between the IMF and the Eurozone countries is likely to impact investor confidence in Greece.

As a response to this crisis EU leaders have proposed a peer review system for national spending budgets to closer integrate economies among EU member states.

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