



THE AGE OF AUSTERITY

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INTRODUCTION

Austerity is the economic theme of the moment, as the crisis in the Eurozone throws greater attention on the level of government deficits and accelerates the need for them to bring these deficits under control. Left to themselves, governments would have preferred much slower reductions. However, the bond market has forced their hands by refusing to fund some countries' high deficits except at very penal interest rates.

An important issue for the property industry, therefore, is the extent to which the actions taken by governments to reduce their deficits will affect the real estate sector, both in terms of occupier demand (and therefore rental growth) and the investment market. We have set out below why government deficits matter to real estate and considered the key implications for the sector of what is currently being planned.

Our overall conclusion is that the retail property sector is likely to be most affected by deficit reduction programmes as higher taxes and lower public sector wages feed through into lower consumer demand. Secondary retail assets seem particularly vulnerable as retailers look to cut costs by eliminating their least profitable stores. The impact on office and industrial property will be less direct, but still significant, as lower government spending leads to lower levels of GDP growth.

GOVERNMENT DEFICITS AND THE ECONOMY

In simple terms, by running a large deficit the government is able to spend more than it would otherwise be able to, thus increasing the size of the country's GDP.

The effect can be temporary, because a high deficit today can mean lower spending in the future in order to repay the deficit. However, some of the gains can be permanent if, as a result of government spending at the bottom of the cycle, the economy makes use of spare capacity that would otherwise have been idle. As a result, it is quite normal for deficits to be increased during an economic downturn in order to try and smooth out the economic cycle.

It is important to differentiate between cyclical and structural deficits. A structural deficit is a long-term difference between government spending and revenues, even when the economy is behaving normally. A cyclical deficit appears because of an economic downturn (due to higher welfare payments and lower tax revenues). When the economy recovers the deficit disappears naturally, without the need for specific action. In fact it is counter-productive for the government to take action, because this delays the very recovery that will ultimately eliminate the cyclical deficit.

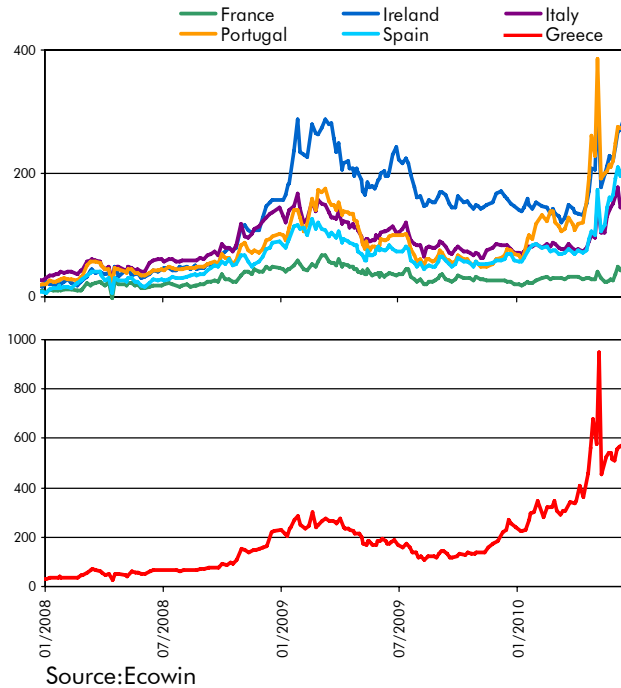
However, deficits can have negative effects as well:

- High government deficits (especially structural deficits) are often associated with low growth and poor productivity;
- They tend to make interest rates higher than they ought to be (thus reducing investment in industry);
- They tend to make wages higher than they ought to be (thus reducing international competitiveness);
- If funded by borrowing from individuals within the country (in the form of those individuals buying government bonds), it may reduce consumption – because people are saving rather than spending;
- If funded by borrowing from financial sources, it reduces investment – because money lent to the government is not available to lend to businesses; and
- If funded by borrowing from abroad, it acts as a drag on the economy as interest payments flow out of the country.

The current crisis means that some European governments are having to deal with their deficits faster than they had originally intended. Before the credit crunch hit there was almost no difference between the yield on German government bonds (which the market generally considers the most desirable) and that on bonds for most other Eurozone countries.

During the latest crisis, in a flight to quality, the yield on German government bonds (and those of other countries considered attractive) has fallen sharply. However, countries that the market considers risky now pay much more to borrow money. A 10-year Greek government bond currently yields 570bps more than the equivalent German bond, meaning that whereas Germany pays just 2.63% pa to borrow money for 10 years, Greece pays 8.33% pa.

Spread on 10-year Government Bonds



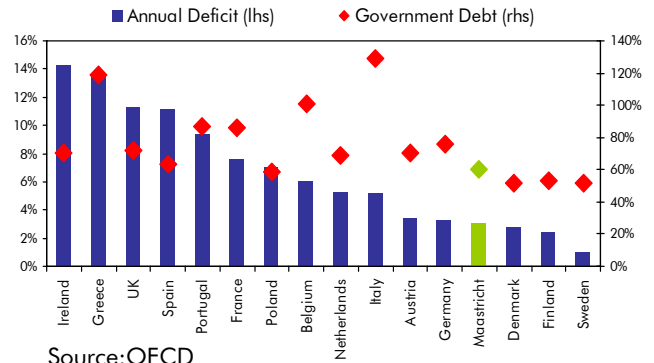
The combination of a high deficit and a high interest rate is not sustainable as ultimately the interest bill will become too high for the country to bear and it will default on its debts. Even those countries where the bond rate has not yet risen are worried that if they don't do something now, they will face the same problem in the near future.

WHERE WILL THE EFFECT BE GREATEST?

Looking at government deficits in 2009 as a benchmark, there are clearly some countries that are in a very much more difficult position than others. Ireland, Greece, the UK and Spain all had deficits in excess of 10% of GDP. Deficits in Portugal and France were also substantial.

At the other end of the scale governments in the Nordic region do not need to take action with regard to their deficits. Deficits in the Benelux area and in Germany and Austria are also manageable albeit above the 3% limit set out in the Maastricht criteria.

Government Debt and Deficit in 2009



The G20 meeting in Toronto agreed as a general principle that governments would halve their budget deficits by 2013, but allowed that each national government would take its own path. Across Europe, therefore, the scale and nature of deficit reduction plans are very different.

Ireland was the first of the European countries to put a detailed plan in place. Through a combination of (mainly) spending reductions and tax increases the proposed budget will reduce the deficit from around 12% of GDP in 2009 to less than 3% in 2014.

Greece has put in place a deficit reduction plan of a similar scale, although given the unrest that has greeted these proposals there may be a question mark over the ability to implement the plans.

Although initially the UK's proposals were more modest, the emergency budget in June means that the UK is now planning to reduce its deficit to 1.1% of GDP by 2016. This too will be through a combination of spending cuts and tax increases, although the emphasis will be on spending cuts.

Spain, Portugal, Italy, France and Germany have also made announcements in recent months regarding their deficits.

Spain – Spending cuts, including a 5% cut in government salaries to reduce the deficit to 3% by 2013.

Portugal – Spending cuts and tax rises to cut its deficit to 2.8% of GDP by 2013.

Italy – Italy's proposals are more modest (reflecting the starting point of a 5.2% deficit in 2009) but include mostly spending cuts to reduce the deficit to 2.7% in 2012.

France – Spending cuts of €100 billion over the next three years to reduce the deficit to 3% of GDP in 2013.

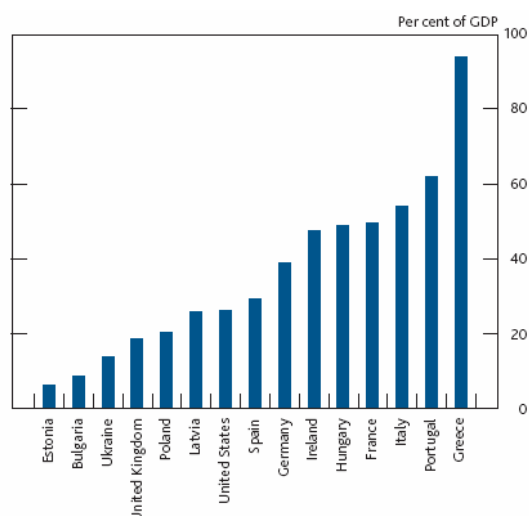
Germany – Spending cuts of €80 billion over the next four years.

The aggregate level of historic government debt, accumulated over previous years, can also be important. Norway will be under no pressure to reduce its annual deficit even though it was nearly 10% of GDP because the Government Pension Fund (built up from years of oil revenues) means that it has a national surplus rather than a national debt. On the other hand the more modest annual deficits of Belgium and Italy are likely to come under scrutiny because they exist alongside aggregate debts that are in excess of 100% of GDP.

High levels of aggregate debt are a particular problem if either:

- It is mainly funded through the issue of short-term government bonds, and therefore a high proportion will need to be refinanced in the near future (driving up the interest rate payable);
- It is mainly funded by external (foreign) lenders, resulting in a net outflow from the country through interest payments.

Proportion of Public Debt Externally Held (2009)



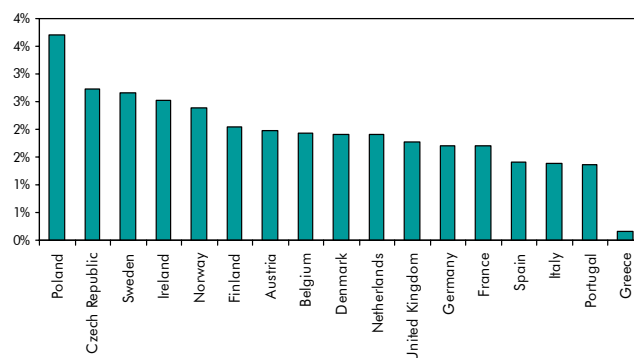
Source: Bank of England, BIS, IMF, OECD, World Bank, Joint External Debt Hub

In most European countries the proportion of government debt that is held abroad is remarkably high. Consolidated information is hard to come by, but a recent Bank of England report suggested that Greece, Portugal, Italy, France and Hungary all had 50% or more of their public debt held by non-residents at the end of 2009.

A final factor to consider is the rate of economic growth. Where this is rapid, the cyclical deficit should decline 'organically' along with this growth and the aggregate debt will shrink as a proportion of GDP. For this reason, deficits in most CEE countries, which are seen as having higher trend growth rates than those in Western Europe, are not generally considered to require action either as immediately or as drastically.

In contrast, slow or negative growth will exaggerate both deficit and aggregate debt problems. This is obviously a huge problem in Greece, where GDP growth is forecast to be negative for the next couple of years. However, it is also an issue for countries such as Italy which have a very slow trend rate of GDP growth.

GDP Growth Forecasts for 2010-2014



Source: Experian

WHY THE EURO MAKES IT ALL MORE COMPLICATED

The Euro makes it impossible for exchange rates to rebalance the competitiveness of countries within the single currency area. Normally when a government runs an unsustainable deficit, what tends to happen is currency devaluation.

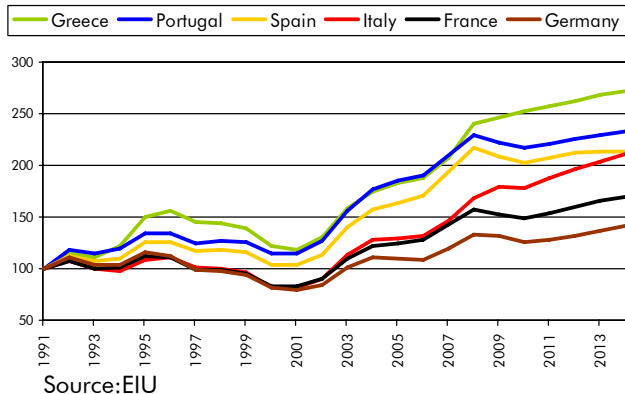
Devaluation shares the pain around all those involved, and makes the effect indirect:

- Devaluation tends to cause inflation; so local savers lose out because cash and the money invested in local assets has a lower purchasing power;
- Devaluation also means that all wages (both in the public and private sectors) have lower purchasing power (effectively a national pay cut)
- Foreign investors (either in government debt or other assets) see the most direct effect because after devaluation their assets in that country have a lower value in their home currency.

The national pay cut that devaluation represents has the effect of increasing international competitiveness; increasing exports, accelerating GDP growth (in terms of the local currency); and therefore reducing both the aggregate debt and the annual deficit.

Such a rebalancing of competitiveness is crucial if the Southern European countries are to grow their way out of their current debt problems. As the chart shows, their unit labour costs have grown enormously relative to the rest of Europe over the last twenty years (since they first entered the ERM and have been unable to devalue).

Unit Labour Costs in the Eurozone



There are long-term negative consequences of devaluation. Interest rates will tend to be higher in the future to reflect the risk that the same thing will happen again. There is also the risk of what is called 'stagflation' (the combination of high inflation and low economic growth), when workers demand higher wages to compensate for the high level of inflation, which itself causes further inflation. These wage rises also reduce the competitive advantage gained from the original devaluation leading to further devaluation of the currency and yet more inflation, whilst economic growth stagnates.

This is the sort of spiral that the UK got caught up in during the 70s. However, the chances of this happening in the UK in the current cycle seem lower because of the weaker position of the unions. Driving up pay at a time of weak economic growth typically requires strongly organised labour. The open labour market in Europe also reduces the risk of stagflation. Importing lower cost labour from the accession countries (which helped to keep down inflation in the boom years) would also have the effect of preventing an inflationary wage spiral from becoming established.

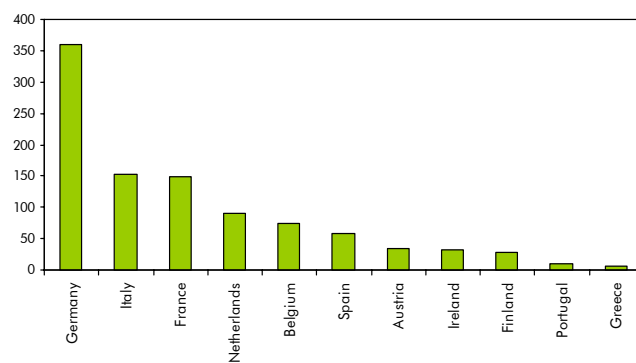
With the Euro in place devaluation is no longer an option for an individual member country. The 'pain' of deficit reduction therefore tends to fall on a smaller group of people:

- local savers do not lose out, because their cash and assets maintain their purchasing power;
- foreign investors (either in government debt or other assets) do not lose out (especially if they are from other Euro countries) because their assets maintain their value in the investor's home currency;

- public sector employees may need to take actual pay cuts (much more obvious than the hidden pay cut caused by inflation);
- private employees usually see tax rises (again much more obvious than the indirect pay cut caused by devaluation).

It is worth noting that the recent turmoil in the Eurozone has made the value of the Euro fall sharply against external currencies such as sterling, the dollar and the yen. This does not help countries such as Greece and Spain improve their internal competitiveness within the Eurozone, but it does help them externally. However, at the moment their exports outside the EU are well below average as a proportion of their GDP.

Exports Outside the EU (€ billion)



There is thus a benefit for countries which do not have a debt crisis, but which already have strong exports outside the Eurozone, as their exports become even more competitive as a result of the fall in the Euro. Germany has by far the largest exports outside the EU, although Finland also has a similar combination of a low deficit and high external trade (relative to its GDP).

DEALING WITH THE DEFICIT

Put in the simplest terms, reducing the government deficit can only be done by cutting spending or increasing taxes. The scale of the impact and where it falls in the economy will depend on the balance of the two.

Higher taxes

The headlines will be full of high profile taxes that are targeted at unpopular groups such as high earners and bankers. However, these tend to raise very little in relative terms. Consider, last year's UK bank bonus tax raised around £2 billion, compared to an annual deficit of £149 billion.

This means that in order to make a real difference there will need to be tax rises that affect a large proportion of the population. VAT and income tax are therefore high on the list of taxes that are likely to increase in the countries concerned. Portugal and the UK have already announced increases in VAT, with Portugal also planning an increase in income taxes.

Such tax increases will have a direct impact on consumption, by reducing disposable incomes.

Lower spending

The vast majority of what government spends is made up of salaries or welfare payments. This is not always directly obvious, as some government activities are contracted out to private sector suppliers, non governmental organisations (NGOs), quasi NGOs or contractors. However, not much of what government does involves consuming raw materials so in the end cuts in spending will result in cuts in the disposable incomes of welfare recipients, government employees and those who are employed by private sector organisations that work for or supply the government.

The vast majority of cuts in public spending will therefore result in lower aggregate disposable incomes, through:

- lower welfare payments (already announced in Ireland)
- reductions in public sector wages (already announced in Ireland and Spain)
- reductions in public sector employment

It is also worth noting that all of these also have the impact of depressing wage growth in the private sector; there are no longer higher paying public sector jobs available, and ex public sector workers are in the labour market looking for jobs. This also has a negative impact on consumption, but ought to increase the rate at which the private sector grows.

The other area where we can expect to see cuts in spending is in major projects. These could be technical (such as the UK's identity cards scheme) or infrastructure. From a governmental perspective these have the advantage that they are quick, high-profile and headline grabbing. Add to this the fact that such projects are generally contracted out, so it appears on the face of it that spending cuts are being made without having to directly cut jobs. However, jobs are still lost, just in the contractors business rather than public sector employees.

Asset sales

A number of countries have announced that they will also be trying to reduce their aggregate debt through asset sales (both real estate and other business assets). While in the context of the total national debt they will be negligible, there could be a disproportionate effect in the real estate sector.

CUTS AND ECONOMIC GROWTH

Directly the public sector tends to make up between 15 and 20% of national GDP. However, some elements of government activity are contracted out to the private sector and other government spending (such as welfare payments) does not count directly as GDP. The more important statistic, therefore, is that in Western Europe total public sector spending is typically between 35 and 45% of GDP.

To make the sort of impact on the deficit that is required in Greece, Ireland, the UK, Portugal, and Spain, spending will need to be reduced by 7-10% of GDP, spread over a couple of years.

Scaling back government spending to this degree will have a very significant impact on GDP growth rates in the countries concerned. Even if the private sector were growing rapidly (which is generally not the case) it would have the effect of slowing growth to well below the trend rate. As things stand, there is a very real danger that such cuts in government spending will significantly reduce overall growth, or even induce the dreaded double-dip recession. Such is the scale of recent announcements regarding cuts in government spending that the double dip recession is now being considered quite likely in some countries, although not in Europe as a whole.

Reduced borrowing

In theory, lower government borrowing can have a stimulating effect on the private sector by freeing up capital to be lent to businesses and increasing demand (because money that would have been borrowed from individuals is now available to be spent). An increase in investment is possible, but in the short term the latter effect is unlikely to be material as surplus income will probably be saved or used to pay down personal debt rather than spent.

CUTS AND THE PROPERTY MARKET

Under normal conditions there is a fairly direct link between GDP growth and occupier demand in the property market. However, these are not normal conditions so it is probable that the link will be more complex.

Retail

The retail sector is the one that is most likely to see a direct effect. As has been discussed above, both cuts in government spending and higher taxes will have a direct impact on disposable incomes and therefore on retail and leisure spending. With lower consumer spending retail businesses have a choice:

- Try to retain sales volume by cutting prices; or
- Retreat to their most profitable outlets.

Both scenarios involve implications for the real estate sector. If they are looking to cut prices, then they will be looking for savings throughout their cost base, including real estate. The least profitable outlets will probably be vacated and elsewhere retailers will be looking to negotiate lower rents. Retreating to their most profitable outlets would also release substantial amounts of secondary space onto the market.

Prime retail locations will probably continue to outperform as, whatever approach retailers take, they will want to maintain their largest and most profitable outlets. However, even in prime locations expect rents to be under pressure. Marginal locations will suffer as retailers look for cuts in expenditure. Secondary retail is therefore likely to face significant challenges over the next few years, with high vacancy and falling rental values.

Falls in consumer spending could also result in more bankruptcies in the retail sector, which would further increase the amount of vacant retail space. Insolvencies have been fairly limited in the cycle so far, and so any retailers that were going to fail would probably have done so already. However, it is possible that retailers who hung on through the recession in the hope of a strong recovery might struggle if this did not materialise.

Offices

The impact on the office sector will vary a lot depending on where government spending cuts are targeted and the extent to which government occupancy is integrated with private sector occupancy.

Total office employment by the public sector will certainly fall. However, this will not necessarily free up office space that will compete in the open market. Many governments tend to occupy clusters of office space within areas of a city that are geographically separate from the main private sector office areas. At the very least they tend to avoid prime office locations for reasons of cost.

In addition, much government occupied office space is of poor quality and would need substantial refurbishment before it would be suitable for reoccupation by private sector occupiers. Owner-occupancy of government office space is also higher than in the private sector and where this is the case they are generally unhappy sharing buildings with non-government occupiers.

Finally, some administrative staff work in operational properties. To give an example, if health service administrators work in office space in hospitals, space in hospitals freed up by reducing the number of administrators could not be leased to commercial occupiers.

In markets where public sector office space is not integrated with the private sector it will therefore be necessary to look at the private sector in isolation in order to judge the possibilities for rental growth. This could still be growing relatively quickly despite falling public spending as not much government spending ends up in the financial and business services sector.

Industrial/Logistics

Lower GDP growth will reduce the overall occupancy of industrial and logistics space. This will result in higher levels of vacancy and falling rental values in the sector. However, as with office space there is a much closer tie to growth in the private sector than the public sector for industrial property.

There are also some behavioural effects that need to be taken into account.

Demand in the logistics sector is strongly influenced by the retail sector (which we have predicted will suffer as a result of deficit cutting). However, the response of some retailers and manufacturers to difficult trading conditions in the past has been to reorganise their supply chains to improve efficiency either directly, or through employing 3PL (Third Party Logistics) suppliers. This was clearly the case in the UK during the early 90s recession.

The short-term effect, therefore, could be to stimulate demand for new, efficient logistics space, despite the fact that overall there will be a negative impact on the sector as a whole.

Investment

Weaker economic growth is likely to further concentrate demand from investors for the types of property that insulate them from short-term movements in the occupier market. Investors will not want to have to re-let premises into what will almost certainly be a weak occupier market with falling rental values over the next few years.

Deficit reduction programs will therefore further emphasise the importance of lease length and covenant strength for most investors and may even increase prices for properties with the right characteristics. At the same time, demand for property with the opposite characteristics – vacancy or short leases – will be weaker as longer potential voids are built into cash flow projections.

Government asset sales of operational property should go well as they typically will be subject to long secure leases. However, such properties have a close relationship with government bonds (effectively they are asset backed government bonds), so there could be significant pricing differentials from country to country.

These assets will also compete with other properties in the investment market. Although at the moment there is a greater demand for prime assets than there is supply, if there is a substantial flow of government assets on to the market this could reverse the balance. The potential size of government asset sales is very large. For example, the French government have already announced plans to sell off some 1,700 buildings (6% of those that they own) over the next three years.

Government asset sales of non-operational property (surplus properties that they do not wish to occupy) are unlikely to be very attractive to investors and typically will sell only at very low prices. As has been pointed out earlier, the market is not particularly keen on opportunities without a guaranteed income stream or where there is the possibility of vacancy in the short to medium term at the moment.

An important indirect effect of weaker economic growth is that interest rates are likely to stay low for longer than had been expected. This lower cost of money will have an impact on property yields, particularly for less risky property where the risk free rate is a more important component of the price.

Geographic effects

An important consideration is that government spending is not evenly distributed within a country. In Italy, for example, government spending is skewed to the South, whereas in the UK the North tends to depend more heavily on government spending. As spending is reduced, therefore, those areas with a high dependency on the public sector will probably be more directly affected.

Finance and development

As discussed, in theory lower levels of government borrowing ought to improve conditions for other borrowers. However, this needs to be offset against the actual and potential losses that banks are being faced with on existing loan books.

In the last couple of months the financing conditions for development had been easing slightly. The current crisis will probably reverse this trend, again focussing property lending on just the safest of opportunities and cutting off the supply of finance again for all but the most 'blue chip' developments.

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