Growth in euro zone hits a six-year high

According to the European Commission (EC), economic growth in the euro zone climbed to an annualised rate of 3.4% in the first half of 2006 – the fastest pace in the past six years.

Despite high oil prices and a slight slowdown in the global environment, the euro economy has expanded rapidly, driven mainly by the rebound in domestic demand, and underpinned by a strong pick-up in investment, high levels of consumer confidence and robust job creation.

The EC said that labour-market performance over the past five years was remarkable, with more than five million jobs created. Employment grew at an annual rate of 1.5% in the first half of 2006 – the strongest rise since 2000 – helping to keep the unemployment rate on a downward trend.

In July 2006, unemployment stood at 7.8% of the labour force – a full percentage point below the peak level registered in 2004.

However, the EC also pointed out that more can be done, with structural unemployment remaining persistently high and employment rates still well below the Lisbon targets.

The EC forecast that in 2007 growth might lose some momentum as interest-rate hikes, tax increases in Germany, a slowdown in the US economy and a deceleration in world trade started to weigh on activity.

However, the EC added: "The broad basis of growth and the fact that it is firmly underpinned by accelerating domestic demand should increase the resilience of the economy to these adverse developments." ■

New players boost leveraged loan market

European leveraged loan and secondary debt markets have surged in recent years and traditional banks now hold only a small proportion of the leveraged loans they arrange.

According to research from Close Brothers, the leveraged loan market grew from €30/35bn in 1998 to €400/500bn in 2005. The German market grew sixfold, Spain four times, France three and a half, Italy two and a half, while the UK doubled.

Merrett: fall-out in prospect.

The banks, which traditionally represented a relationship and point of stability for corporate borrowers throughout the business cycle, now hold relatively little economic interest in a loan following syndication.

Andrew Merrett, a Director in the European Special Situations Group at Close Brothers, said: "This is a huge escalation in the amount of debt companies are carrying. Many of these loans are equity by another name, and have been made to borrowers of poorer credit quality. This in itself will cause default rates to rise whatever happens in the wider economy. But with the upward pressure on interest rates, these structures will be severely tested. And there's going to be fall-out."

The proportion of interest-only tranches of leveraged loans being allocated to non-banks is reaching 75%. The non-bank lenders taking up the syndication are mainly collateralised loan obligation (CLO) funds and hedge funds.

CLOs are unable to hold distressed debt for regulatory reasons, so where there is a risk of default they are forced to sell debt into the secondary market, where it is typically bought by distressed debt traders and hedge funds.

Merrett said: "The prevalence of non-bank lenders has led to an erosion of the established rules and frameworks for the work-out of distressed situations. The trading mechanism for bank debt does not necessarily allow the corporate borrower or sponsor to know when a trade occurs, or to whom the economic interest has been sold. Companies and sponsors could be blind as to who the underlying economic investors in their loans are." ■

Decision time on standards

Stakeholders in international accounting will have to decide whether future standards should be based on principles or rules, according to the chairmen of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB).

Speaking at an IFRS 2006/7 conference organised by Euromoney in October, IASB chairman Sir David Tweedie said that preparers, users and regulators had to decide whether they wanted key standards on issues such as financial instruments, leasing and pensions to be short, principles-based standards that relied on both preparers and auditors to use their judgement, and which could not be second-guessed by regulators. The alternative was long, detailed "cookbook" standards that tried to envisage and deal with every possible option and scenario.

Tweedie made it clear he preferred principles-based standards where there were no exceptions, no inconsistencies, and which related to a conceptual framework and had minimum guidance. But he warned that rules-based standard would have to be adopted if preparers did not act with integrity, if reasonable judgements were attacked in court, and if the standards produced unacceptable results. He also warned regulators that they could not expect one answer under principles-based standards.

Bob Herz, chairman of FASB, said the US was interested in international convergence as a global capital market implied global standards, and that although a *pax Americana* in financial reporting was unlikely, any truly international solution must include the US.

Herz backed Tweedie's stance on principles but cited the principles versus rules debate as one of the challenges to convergence. Other challenges included different countries starting from different places, cultural, institutional, regulatory and legal issues and the problems of getting standard-setters to agree. ■