



The Good Oil on Greece

What's happening with the debt crisis?

We may share beautiful beaches, blue waters, and a love of food and wine, but that's just about where the similarity ends between Australia and Greece at the moment.

While the Euro zone struggles with a huge blowout in Greece's debt levels and the fear of massive defaults, not only is this unlikely to occur in Australia but the impact on Australian investments is expected to be minor.

In any case, the general view is Greece will pull out of the crisis by tightening its belt and receiving assistance from the strong economies of the European Union – France and Germany.

STRINGENT MEASURES

The new Greek government has already announced some stringent measures to curb public spending and while the trade unions and some political groups are up in arms, early pointers are that the people will pull together for the good of the country that established the principles of democracy.

The new measures include lifting retail sales tax from 19 to 21 per cent, cutting public service salaries, and introducing a pension freeze.

For a country where public servants get 14 months' pay each year, employees in 580 occupations¹ have a right to retire at 50, and for some residents the pension kicks in at 58, outsiders see plenty of room to pick up the slack. But unless local resistance to major change is managed effectively, it may prove an uphill battle.

Central to the crisis is that the whistle has been blown on Greece's escalating and unsustainable national debt – as it has for other countries such as Iceland and Ireland. However, the timing has left Greece standing alone in the world's spotlight just as the US and much of Europe believed the worst of the Global Financial Crisis was over.

DEEP-SEATED ISSUES

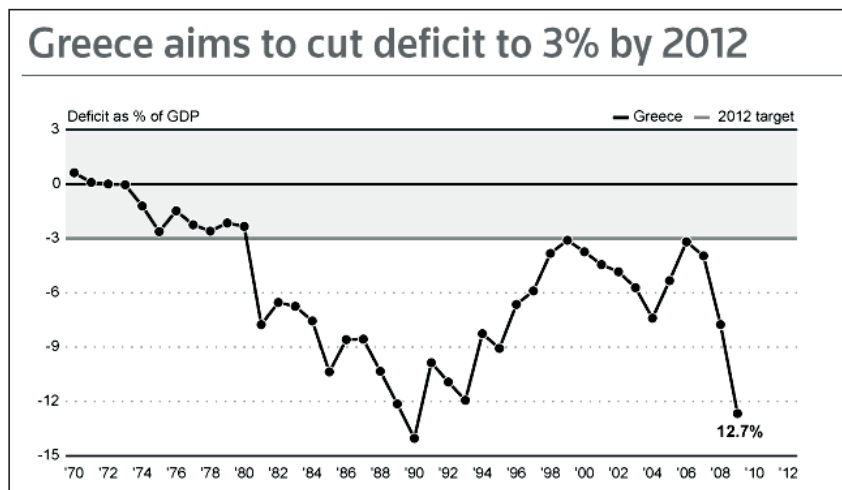
And it's these deep-seated issues that have contributed to the poor performance of the Greek economy over the years. Indeed, large budget deficits have been the name of the game for many a year, although up till now it has largely been covered up with the help of Wall Street. The Maastricht Treaty, which was signed by members of the European Union back in 1992 to establish the Euro, required each country have a budget deficit of no more than 3 per cent of gross domestic product (GDP). Greece has only achieved this figure once since it adopted the Euro in 2001. And currently Greece's budget deficit is four times this level at 12.7 per cent although it has pledged to reduce this to 8.7 per cent through the course of this year.

Most of Greece's debt is not internally funded but is owned by foreign governments and investment houses. The crisis has come to a head now simply because most of these debts are due to be rolled over in April and May.



One answer to budget deficits that has been employed in numerous countries over the years is to devalue the currency by printing more money. This allows you to pay for the excessive spending. Such a move usually ends up increasing inflation, but that can help by eroding the real value of the debt. However, because Greece adopted the Euro, it has to abide by 'team rules' and cannot act unilaterally to ride out the current storm. This Euro discipline contributes to the problem by denying Greece a 'quick fix'.

Nevertheless both Germany and France have indicated they will support Greece to get through the current crisis, although this is still being nussed out.



PAYING THE PRICE

Meanwhile Greece has already witnessed strong demand for a recent \$7.48 billion bond issue, reflecting investor confidence that the country will not default. However to encourage foreign investors to take up this bond issue, Greece had to offer an interest rate of 6.25 per cent which is 3 per cent higher than benchmark German government bonds. As a result, re-building confidence has come at quite a price, certainly compared to other countries. And because it costs more to service the loan, its effectiveness is partly undermined.

While there's plenty of talk that other southern European countries including Spain, Portugal and even Italy are not far behind Greece in the debt stakes, economist at the Grattan Institute, Saul Eslake, believes all will survive. He cites the example of Ireland which also ran into trouble, but the willingness of its people to tighten their belts averted any major crisis.

IMPACT ON AUSTRALIA

Glenn Stevens, head of the Reserve Bank, plays down any impact on the Australian economy. "I do not think myself, at this point, that those issues will directly present a serious problem for Australia. After all, it is a sovereign debt issue for Europe." Nevertheless, the RBA made extended comments on Greece and sovereign risk in the minutes of its most recent meeting.

If the southern European debt problems spread to other northern hemisphere economies such as the UK and the US, this could dampen demand for commodities and in turn unsettle share markets. But on the bright side, it certainly makes holidays in Europe, including Greece, look decidedly appealing.

To cushion against anything untoward happening, diversification in your investments continues to hold the key. A diversified investment portfolio should shelter you from the storm. In any case, while the fall out from Greece might well make for some uncertainty in the coming year, it is unlikely to be a global tragedy.

1. www.nytimes.com/2010/03/12/business/global/12pension.html



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