

Greece may seem like a remote concern for most Australians. Some investors may be worried that the turbulence in Europe may mean bad news at home. So, what is the current situation in Europe and how could it affect investments?

Some background

Much of Europe is struggling with large amounts of government debt. Greece, in particular, has been hitting the headlines lately due to its debt levels and poor economic history, causing considerable concern. Portugal and Ireland have had similar woes, although their economies have been on a sounder footing. On top of all this, the focus has shifted to Spain and Italy where government debt levels are also high.

The International Monetary Fund (IMF) was created at the end of WWII in order to create global economic stability. Part of its function is to grant loans when and if needed. These are generally referred to as 'bailouts' as they are designed to bail a country out of its debt. Greece, Portugal and Ireland have all received bailouts recently from the IMF, which works in conjunction with the European Union (EU) and the European Central Bank (ECB). These three institutions when combined in this situation are commonly referred to as the 'Troika' (meaning in Russian a collection of three).

As vital as these bailouts are for some countries, the conditions of receiving them generally include government spending cuts and tax increases, known as austerity measures. Spending cuts and tax increases tend to slow economies. Sluggish economic growth limits a country's ability to recover. This means that bailouts can be a 'double-edged sword' and may not always be the best solution to debt problems. It is not really Greece itself which is of greatest concern, but rather the way that the Troika choose to deal with Greek government debt in the long term. This will set a precedent that may determine the outlook for the entire eurozone.

Greece

Greece has already received many billions of dollars in bailout funds. Its debt is far more than the sum of its gross domestic product (GDP) and it therefore has a very high debt-to-GDP ratio. This means that it owes far more money than its economy produces each year. A more concrete bailout package was announced on 21 July by the *Heads of State or Government of the Euro Area and EU Institutions*, which secures financing for Greece till 2014 at a lower interest rate. This is a step in the right direction and shows the commitment from the Troika to resolve this significant issue in global financial markets.

However, there is concern in financial markets as to whether Greece can really tighten its belt and reduce the sheer size of its government debt, even with this new package. The focus really needs to be on economic growth. With Greece currently in recession, a package designed to return the country to growth is key.

In the package announced in late July, there was focus on introducing, "a comprehensive strategy for growth and investment in Greece ... to target structural funds on competitiveness and growth, job creation and training ... to relaunch the Greek economy"², which is encouraging.

To date, one of the biggest worries for the eurozone is that government debt in peripheral European countries is owned within the banking system (ie the banks are owed money by their own governments). Government debt problems could potentially turn into a banking crisis; once again the focus of the 21 July package is to provide a backstop to the banking sector in the event of a crisis.

It is important to remember that Greece produces only 0.5% of global GDP, whereas Italy and Spain produce 2.4% and 1.9% respectively.³ If Greece does eventually default (which is likely and now almost expected), the flow-on effects, while negative, may not be catastrophic. This expectation itself provides a kind of cushioning effect on markets; the expected managed defaults are to some degree already factored in. While the Greek situation is slowly being resolved, a permanent situation is still lacking and the same questions will arise for Ireland, Portugal and perhaps Italy and Spain, yet on a much larger scale for the latter two. We continue to believe that a long term resolution to the Greek situation will be a lengthy process which will ultimately affect the viability and structure of the EU itself.

Italy and its debt

Italy's government debt level is also above its GDP. However, there are several reasons why Italy is in a very different situation to Greece. Firstly, Italy has a stronger track record of financial discipline and lower debt-to-GDP ratio than Greece. Additionally, the Italian government has already implemented several rounds of spending cuts. Italy also has a large pool of private savings, including one of the largest pension markets in the world. A high proportion of Italian debt is held by domestic investors, so there is less reliance upon international financial markets for funding. We believe that concerns regarding Italy's total debt are valid, but Italy is in a much better position to Greece and has a more optimistic outlook.

Spain is also a concern

The market has also recently turned its attention to Spanish debt. Spain's debt-to-GDP ratio is lower than Italy or Greece's, but it does have a higher budget deficit. Unlike Greece and Italy, it regularly posted budget surpluses until the global financial crisis. Spain has also proactively implemented structural reforms and tighter fiscal policy and has reduced its deficit.

Spain is aiming to reduce this deficit further and, generally, government spending is on target. While suffering from higher unemployment than Italy, we still believe that Spain will be supported by its diversified economy and its commitment to getting back in the black.

How does this affect Australia?

Global economic worries may have various effects on Australia. When coupled with other issues such as US debt dramas, it may leave investors lacking in confidence. This generally translates to less trading, lending and spending by both companies and individuals. There could be some volatility in funds that have exposure to the affected parts of Europe. Speak with us if you have any concerns.

The Australian economy is not overly reliant on Europe, and has a far more positive outlook. The Reserve Bank of Australia noted at its July meeting that, "Australian credit markets continued to be relatively unaffected by the global uncertainty over the past month"⁴, despite the European turbulence. Moreover, despite the many factors at play, it "considered that the continuing strong economic performance of Asian economies meant that the medium-term outlook for the Australian economy remained strong"⁵. This is due to the strength of our resources sector and subsequent export potential. As such, the Australian economy overall appears to be relatively shielded from any European fallout.

Conclusion

Although bad news can be unnerving when it comes to investments, it is important to keep things in perspective. The Greek economy is small when compared to its neighbours and European officials seem determined to arrive at a solution – the 21 July package is a step in the right direction. Finally, Australia appears to be fortunately placed; our links to the stronger Asian economies and relatively low levels of government debt should help our economy weather the storm.

1 Wikipedia, <http://en.wikipedia.org/wiki/Troika>, July 2011.

2 Council of the European Union, *Statement by the Heads of State or Government of the Euro Area and EU Institutions*, Brussels, 21 July 2011.

3 International Monetary Fund, as at 31 December 2011.

4 Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board*, 5 July 2011.

5 Reserve Bank of Australia, see footnote 4.

Speak to us if you would like to discuss how the European debt crisis may be impacting your investments.

Important information

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