June 2012

Is it Grexit, stage right?

Snapshot

The European debt crisis and the problems in Greece continue to spook global financial markets and have given rise to a new word: Grexit, or 'Greek-exit'.

Of course, this new word refers to Greece's possible exit from the Eurozone and re-adoption of a much-devalued drachma. However, this sort of national exit strategy was not written into the Maastricht treaty under which the European Union and the euro were established, so it could set a dangerous precedent and expose other vulnerable countries.

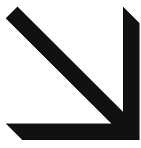
Having a single currency across many countries—including the likes of Germany with a very strong economy, and Greece and Portugal with weaker economies—has its problems. Critically, the traditional option of devaluing a currency to kick-start a struggling national economy is not possible with a single currency.

Contagion – a real fear?

Greek's debt crisis began years ago but now it's crunch time with foreign debt of E422 billion. While this is no doubt a staggering sum, it is important to put Greece into some perspective. It is the world's 38th largest economy — Australia is ranked No.12 — which puts Greece on a par with Chile and Nigeria. Greece accounts for 1.3 per cent of all Eurozone deposits compared with Germany's 20.7 per cent.

But there is no precedent or neat solution for the current situation, giving rise to the fear that a disorderly exit back to the drachma could cost $US1 trillion and the European economy could contract 5 per cent. It is not possible to estimate the various knock-on effects, particularly considering a weakened banking system among countries already in recession.

The Eurozone would need to establish a 'firewall of confidence' so the contagion does not spread to Portugal, Spain and even Italy. While Portugal only accounts for 1.6 per cent of Eurozone deposits, Spain constitutes 10.7 per cent and Italy 10.1 per cent.



The crunch comes on June 17 when Greece goes back to the polls after the inconclusive May 6 elections. While anti-austerity votes were on the rise then, many believe it was a protest vote and the pro-austerity factions will win in June.

Whatever the outcome, the fear associated with this crisis has rocked global financial markets. Global shares have dropped around 10 per cent from their highs in April 2012, while Asian and Australian shares are down by a similar amount.

Against this backdrop, the global economy is in much better shape than it was this time last year. US housing and manufacturing are growing, Japan is recovering, global car manufacturers no longer face supply chain disruptions, shares are cheaper, and bonds are more expensive. These are all positives. There is also some easing in monetary policy in China, other emerging countries and in Australia, and this should stimulate further growth.

Demand for US Treasury bonds, the traditional safe haven in times of uncertainty, has recently shot up. This has strengthened the US dollar at the expense of the Aussie dollar leading to its fall below parity. A weaker Australian dollar is positive for many businesses, particularly those in hard-hit industries such as tourism, manufacturing and retail. It also increases the chance of lower interest rates and, in turn, lower mortgage repayments.

Former Treasury head Dr Ken Henry says Australia, too, will be seen as a safe haven and this is being reflected in the growing demand for Australian bonds. The yield for Australian bonds is now at historical post-war lows of less than 3.2 per cent. With such low returns from bonds, high-yielding companies, paying solid franked dividends, will ultimately prove more attractive for investors, and this should help improve sentiment.

Impact on Australia

Despite the world's focus on Greece and the volatility in global financial markets, at first glance it seems Australia is not directly affected by the fallout. Our exports to Europe represent less than 8 per cent, for example. However, if Greece were to exit the Eurozone in a disorderly fashion and other European economies weaken further, this would impact China and in turn would knock demand for Australian commodities. Shane Oliver, Head of Investment Strategy & Chief Economist at AMP, estimates that a 5 per cent fall in Eurozone GDP would knock roughly 0.4 per cent off Australian economic growth.

Much of the problem in Europe is the discrepancy between the strong and the weak economies. Some argue that rather than have Greece leave the Eurozone, the country to exit should be Germany, the strongest. The consequential devaluation in the euro, without Germany, would make the exports of remaining Eurozone countries more competitive and enable these countries to better deal with debt.

While this scenario is unlikely, Grexit is also not a foregone conclusion.

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