

European sovereign credit risk – Some thoughts

Economic note

12 February 2010

- Financial markets are concerned that credit risk in Greece could spread to other European countries and threaten EU stability and the euro.
- The budget deficit and debt levels in Greece and some other countries in Europe are very high and are a serious matter for the countries involved. Significant fiscal tightening will be required by these countries to restore credibility and stability.
- This fiscal tightening will likely act to slow economic growth in the EU for a number of years to come. The alternative of serious questions being asked about the sustainability of the EU and euro is, however, not an outcome the major European countries would countenance.
- This means that support for Greece would likely come from the larger economies in Europe, or an international body, if this was required. But the price Greece would have to pay for this support would need to be high enough to stop other countries contemplating this option.
- The direct economic impact of these developments on Australia is very low, as we are now in the Chinese economic orbit. But any concerns over 'risk appetite' do impact on Australia. A resolution to this issue will be important for global markets.

It's all Greek to me:

Global financial markets have recently come under pressure over concerns about sovereign debt levels in Europe, especially in Greece and other countries such as Portugal, Italy and Spain (affectionately known in the markets as the 'PIGS', or "PIIGS" if you include Ireland). While the fiscal and debt situation for these countries is very poor and a significant issue for each of them, the amount of money involved and the relatively small size of each economy means that the direct impact on global economic activity should be minimal. Why then have markets focussed so heavily on these developments?

One of the key issues in this regard is concern that what is happening in Greece is just the tip of the iceberg for sovereign debt worries. What is increasingly clear is that those countries that entered the global financial crisis with poor fiscal fundamentals are now suffering heavily from the combined effect of having to ramp up government spending to offset the impacts of the recession and from the sharp falls in revenue that has occurred as a result of the downturn, i.e. bad budget positions have been severely hit by recession and the need to, effectively, transfer some of the bad debts of the banking system onto the public sector.

For Europe the issue is two-fold: Firstly, a default on the debt held by a member of the European Union (EU) would likely severely damage the markets view on the sustainability of the EU and, perhaps more importantly, the euro itself.

Secondly, the need to significantly tighten fiscal policy will likely act as a brake on economic activity for some of Europe’s largest economies for many years to come, keeping the second largest economic region in the world growing at sub-par rates – which in turn would likely lower global economic growth.

The direct impact on Australia of these developments in the EU is small. However, Australian markets (especially the equity market and the AUD) have suffered heavily over the past week or so – just like other major markets around the world. The issue here is global risk appetite. Sovereign debt worries in the EU have led to a generalised reduction in risk appetite around the world and this has led to some selling pressure on the AUD (buying of the USD as the EUR has been sold) and weakness in global equity markets, including Australia.

While the announcement by the EU Commission overnight that they will offer support to Greece (see below for details) is a positive development, the concern remains that the fiscal/debt position of a number of European governments is unsustainable. Long-term remedial action is required and, therefore, this is an issue for the markets that is unlikely to fade fast. Markets are likely to remain concerned about contagion risk, spreading from Greece to the other PIGS and even to countries such as the UK.

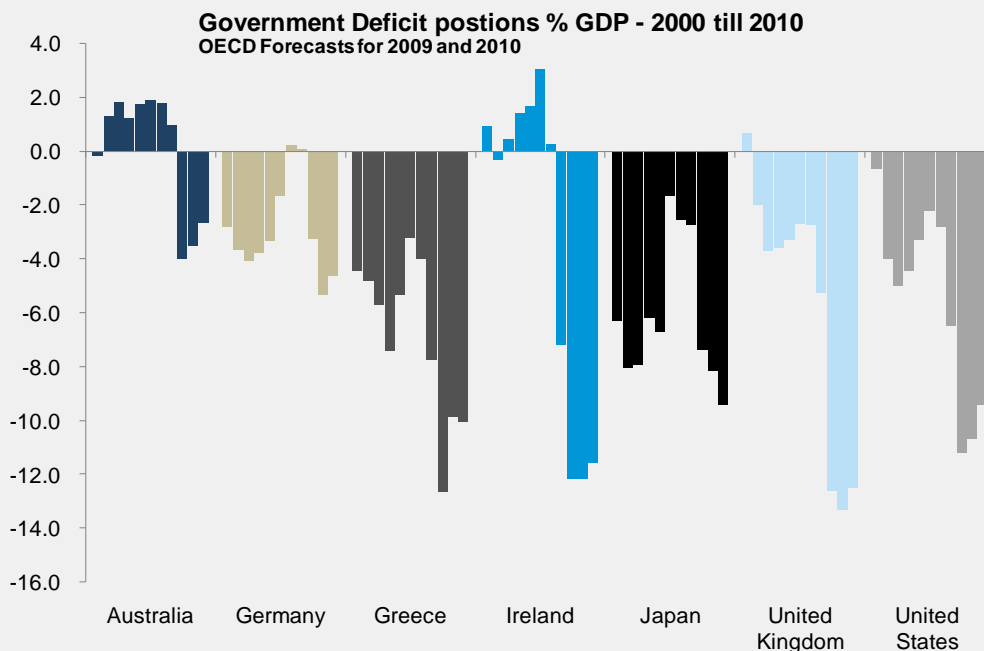
From Australia’s perspective, our very strong fiscal fundamentals have not provided much of a buffer for markets in recent weeks. But it would seem sensible to suggest that, over time, markets will become a little more discerning and offer Australia some benefit from our much better fiscal position.

The other key issue for Australia is, of course, that we are now in the Chinese economic orbit and not in the EU orbit, so the part of the world economy that is most important to us is likely to continue to outperform other major economic regions.

The facts on Greece:

In fiscal year 2009 Greece is estimated to have a budget deficit of 12.7% of GDP. This is a massive deficit. As can be seen in chart 1, Greece’s budget deficit is very high compared with some other major OECD nations, although consistent with the levels seen in Ireland (12.2%), the UK (12.6%) and the USA (10.7%). (Note how small Australia’s budget deficit is in comparison). What is also critical in this regard is that Greece had a very poor budget position at the onset of the global financial crisis, with deficits averaging around 3%-5% of GDP.

Chart 1 – OECD nations’ General government budget deficit

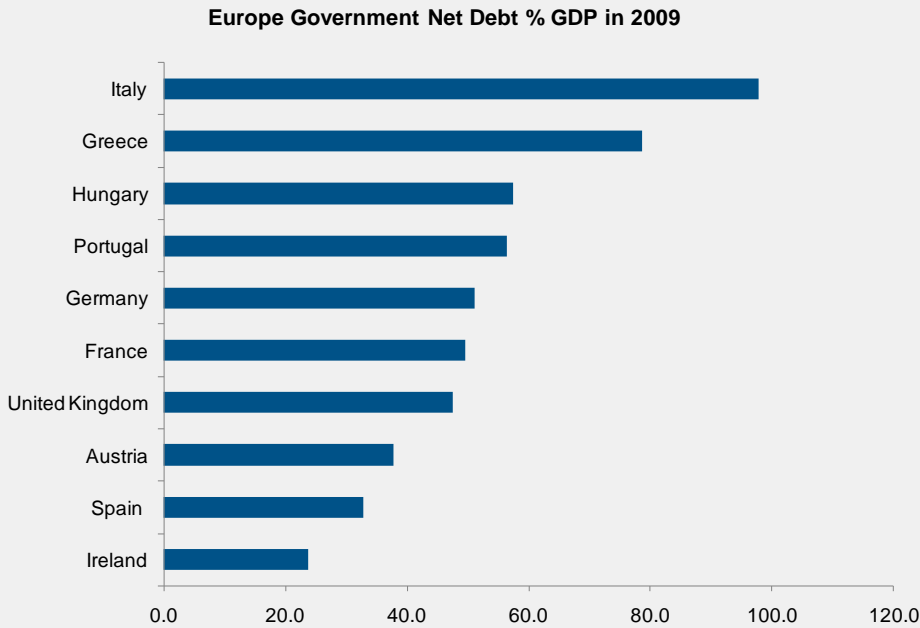


Source: OECD

Because of their very poor fiscal position over a number of years, Greece has a very large level of accumulated debt, estimated by the OECD at just under 80% of GDP in 2009. This is the second largest of the main EU nations, just behind Italy at close to 100% (see Chart 2). (Note, Australia’s general government net debt is estimated at 3.7% of GDP in 2009/10).

For 2010 Greece needs to borrow around EUR53bn (approx. \$A81.5bn), the equivalent to around 20% of the economy. EUR25bn of this is due in the April/May period. This will obviously be a critical period for Greece and the markets. Estimates for Q3 09 show that 77% of Greece's debt is held by foreign investors.

Chart 1 – OECD nation's net financial liabilities (net debt)



Source: OECD

The Greek government has already announced a budget plan to reduce the annual budget deficit from 12.7% in FY2009 to just 2% by FY2013. Market confidence that Greece will be able to achieve this target is, however, very low.

The Greek government has proposed moves such as a significant cut in public sector wages (-6% in nominal wages) and wage supplements (-10%), along with a 10% reduction in the remuneration for the Prime Minister and other government ministers. In addition, the income threshold for the highest income tax rate of 40% has been cut from EUR75k to EUR60k. Partly in response to these measures, Greece's 600,000 public sector employees went on a 24 hour strike this week, closing down schools, hospitals and airports. Opinion polls have suggested, however, that the Greek government has wide support from the population to implement the fiscal and economic steps needed to restore Greece's economic prospects.

The EU response:

Overnight the "Heads of State or Government of the European Union" have released a, very short, statement on the situation in Greece. In part the statement reads "we fully support the efforts of the Greek government and their commitment to do whatever is necessary, including adopting additional measures to ensure that the ambitious targets set in the stability programme for 2010 and the following years are met. We call on the Greek government to implement all these measures in a rigorous and determined manner to effectively reduce the budgetary deficit by 4% in 2010."

"We invite the Ecofin Council to adopt at its meeting of the 16th of February the recommendations to Greece based on the Commission's proposal and the additional measures Greece has announced."

"The Commission will closely monitor the implementation of the recommendations in liaison with the ECB and will propose needed additional measures, drawing on the expertise of the IMF. A first assessment will be done in March."

Significantly the statement then adds "Euro area Member states will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole. The Greek government has not requested any financial support."

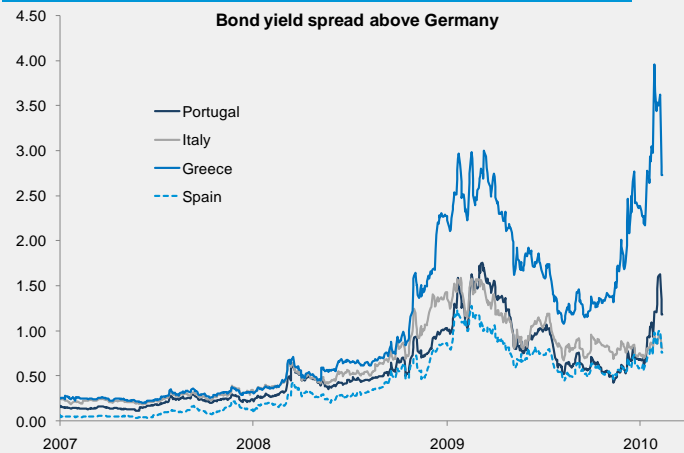
Media reports after the release of the EU statement were that the details had been agreed by the German Chancellor, the Greek PM and the president of the ECB. German Chancellor Merkel was quoted as stating that the declaration was a "clear political message to Greece."

That message seems to be: we know that you have a significant budget/debt problem, you must do everything you can to solve this issue and restore market confidence in the EU and euro and if you don't then we, or an international body, will step in to ensure that the necessary fiscal steps are taken.

Market impact:

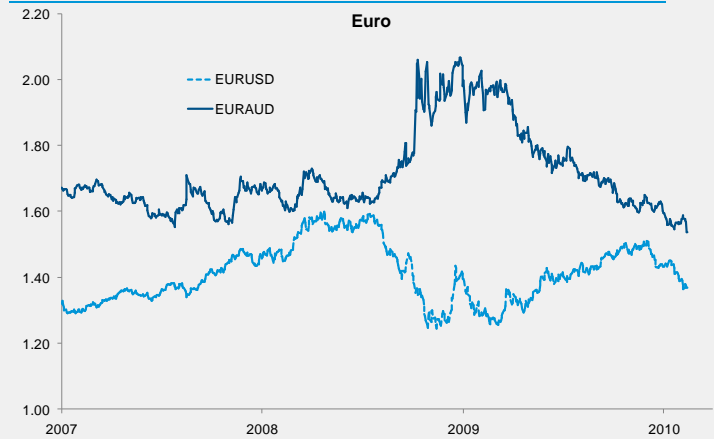
The following two charts tell the story. The left hand chart shows the spread of bonds issued by Greece, Italy, Spain and Portugal over Germany – remember that these bonds are all in the same currency. Clearly the markets are charging the PIGS a higher interest rate to fund their debt – a reflection of the credit concerns. On the right hand side, after being stronger for much of 2009, the EUR has started to weaken sharply against the USD as the markets worry about EU credit risk and a slower EU economy. Clearly the AUD has shown relative strength against the EUR.

PIGS bond spreads to Germany



Source: Bloomberg

EUR/USD and EUR/AUD



Source: Bloomberg

Where to from here:

Some sense of calmness has descended on the markets following the EU statement last night, but further work will be needed to convince markets that this issue has been solved. The key issues, as we see them, are as follows:

- The budget/debt situation in Greece is very bad. Years of poor fiscal management have been exacerbated by the global financial crisis and subsequent recession.
- The other members of the EU have made it very clear that the Greek government needs to implement the, very stringent, fiscal policy plans they have announced to bring the deficit under control.
- If Greece is unwilling or unable to do this, then the EU (likely led by Germany) or an international body, will intervene in some way to ensure that Greece can service its debt.
- The price that Greece will pay for this fiscal intervention must be sufficiently high to ensure that other countries (i.e. Spain, Portugal etc) do not see this as an attractive offer.
- The major EU countries (Germany, France) are not willing to allow the smaller countries to bring the sustainable and stability of the EU and euro into question.
- This issue is unlikely to be resolved in the short-term and will take years of tighten fiscal policy to correct the situation.
- Markets are likely to continue to fret about sovereign debt risks for some time to come.
- The fiscal policy tightening needed to help stabilise the situation will act to slow the rate of growth of Europe for a number of years.
- The direct economic impact of these events on Australia is low – we are now in the Chinese economic orbit, not Europe.
- But any global reduction in risk appetite clearly impacts on Australian markets, making a resolution of this issue an important goal for the global economy and global investors.

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