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Some considerations on the current ructions in Greece

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What is the background to the current crisis in Greece?

The Greek government is currently on the verge of 'defaulting' or refusing to make any more payments due on loans provided to it to help it weather the recession that it has been enduring for the last 8 years. The background to this is that the country has been hit hard by a build-up of debt in recent years. While government debt was relatively contained until the beginning of the global financial crisis in 2008, it quickly accelerated after that, with net government debt forecast to reach 170% of GDP this year, after peaking at 174% last year, according to the International Monetary Fund (IMF).

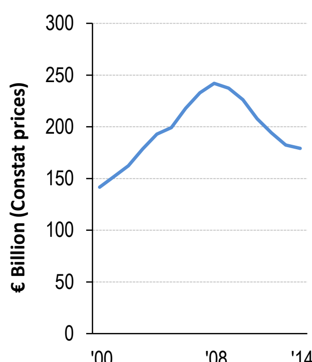
The underlying problem was that prior to the global financial crisis that began in 2008, costs (including wages) in Greece had risen faster than in other countries in the European Union. Effectively the country had become relatively uncompetitive. At the same time, the Greek government attempted to keep welfare payments up and these grew as a proportion of GDP until 2011, when government spending peaked at 54% of GDP. Since then, under political pressure primarily from the European Union (as well as from the European Central Bank (ECB) and the IMF), 'austerity' measures have been introduced and these have seen government spending decline to an estimated 44% of GDP this year. These 'austerity' measures, including cuts to pensions, wages and public services, were imposed as a condition in order for Greece to continue to receive continuing loans on favourable terms from these institutions.

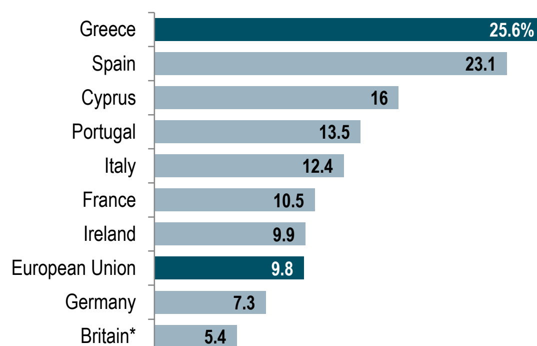
Unfortunately, however, Greece has been unable to emerge from the very severe recession that followed the onset of the global financial crisis. Real (inflation-adjusted) GDP for 2015 is estimated by the IMF to be down 24% from 2007 levels, while the official unemployment rate is 25%, despite high levels of emigration by those seeking work.

In this environment, the general populace has understandably become extremely restless and is seeking an end to the pain caused by austerity and high unemployment.

Greece's G.D.P. and Unemployment Rates in Europe

First quarter 2015 average; *Britain is the three-month average through February.





Source: Eurostat

In many other countries, one mechanism that could have been employed to relieve some of the pressure on the economy would have been a devaluation of the currency, which would be expected to provide an immediate lift in competitiveness and, in Greece's case, would be likely to lead to a strong boost to the country's major industry, tourism. However, this option of dropping the value of the currency is not (yet) available as Greece remains a member of the Euro zone, with the Euro as its currency.

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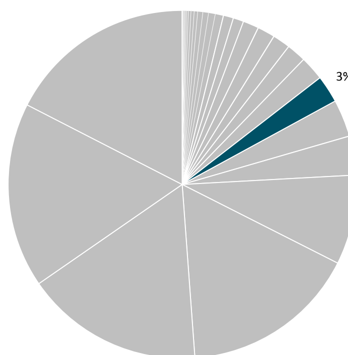
What is next and is it as negative as is currently portrayed by some media?

The Greek government is clearly weighing up the option of leaving the single currency and going back to its own currency (formerly known as the Drachma); and in many ways this could be the most sensible option to help this economy emerge from its deep recession over time, especially if this can be done with help from the ECB in managing such a transition. One of the consequences of this though would be that the borrowings that the Greek government needs to service would become even more unaffordable than they already are and Greece would probably have to 'default' on its loans, which would mean that its debts would have to be 'restructured', implying that lenders (including some German and other European banks) would have to take so-called 'haircuts' on the value of their loans, meaning that there could be sizeable losses for these lenders. In turn, this could lower the value of banking institutions that hold Greek debt on their books as assets, although the largest losses would likely be borne by European taxpayers.

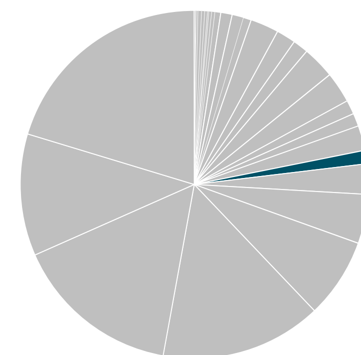
It is important to keep in mind that Greece is a small part of the European economy, and that Greek government debt only amounts to around 3% of total European government net debt

However, it is important to keep in mind that Greece is only a small part of the European economy, accounting for only 1.3% of European GDP this year (according to IMF estimates). Furthermore, there is little industry in Greece, other than tourism. Therefore, the direct effect of any decision by Greece to return to its own currency would likely be minimal except in the case of European banks that have lent to the Greek government and even in relation to this, it should be remembered that Greek government debt only amounts to around 3% of total European government net debt.

Greek Debt in Comparison to Total European Union Debt



Greek GDP in Comparison to Total European Union GDP



Source: Eurostat, IMF

This overblown level of rhetoric has had a negative but perhaps exaggerated effect on many share markets

It is also true, however, that European negotiators have dealt with the Greek government in a ham-fisted way, while a number of European politicians have raised their rhetorical pressure on the Greeks to a high level, with the aim of convincing Greece to continue with its 'austerity' program and stay in the Euro, thereby (at least on paper) maintaining the full value of their taxpayers' loans to Greece. This overblown level of rhetoric has had a negative but perhaps exaggerated effect on many share markets.

What about my exposure to international equities?

Global share markets have reacted to the increasing likelihood of a return by Greece to its own currency by falling over recent days (the. broad US market was down 2% from 1 June to 30 June, while the UK, German and Japanese markets were down respectively by 7%, 4% and 2% and the Australian market was down 6%). As such, it may be that these markets have now already priced in the worst of any reaction to news from Greece. We currently do not intend to sell our holdings in the international equities sector, especially as Greek share holdings are minimal. Furthermore, if a settlement of the current stand-off between creditors and the Greek government is able to be negotiated over coming days, markets could potentially react positively, although some further market volatility could be expected.

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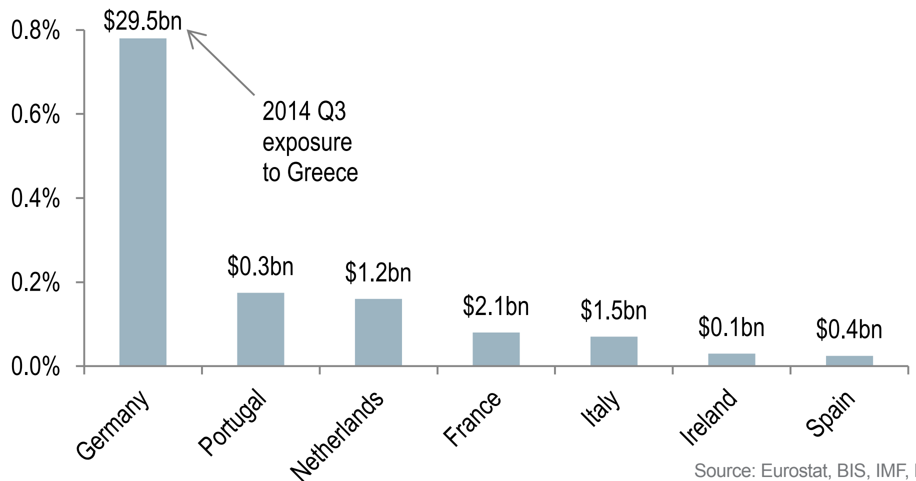
What about the so-called ‘contagion effect?

‘Contagion’ is the term used to describe the potential for other countries to follow the Greek example. If Greece returns to its own currency and this eventually proves to be a successful move, then other countries that have been labouring under the weight of large debt burdens and which are also struggling to emerge from recession, including Portugal, Spain and Italy, could perhaps try to go down the same route and return to their own currencies. However, any such outcome is not likely to eventuate until well into the future and anyway may not necessarily be a bad thing for the countries concerned.

Since Greece’s debt crisis began in 2010, most international banks and foreign investors have reduced their Greek bonds and other holdings, so they are no longer as vulnerable to what happens in Greece.

This is not another global financial crisis and it is small scale in relative terms. Markets can be expected to soon adjust

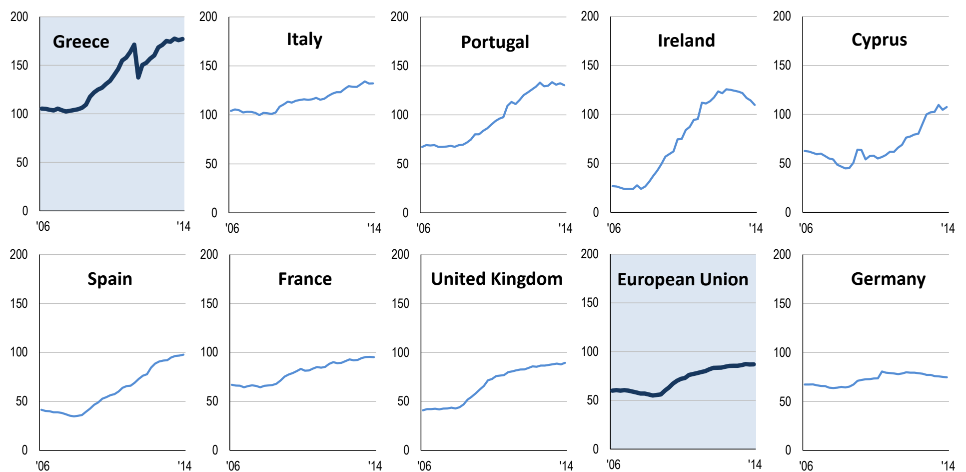
Domestic Banks Exposure to Greece as a % of GDP (2014 Q3)



Source: Eurostat, BIS, IMF, PWC

In the meantime, other vulnerable countries in the eurozone, including Portugal, Ireland and Spain, have taken steps to overhaul their economies and appear to be less vulnerable to ‘contagion’ than they were a few years ago.

Gross government debt as a percentage of gross domestic product plotted through the fourth quarter of 2014



Source: Eurostat

What does all this mean for my investments?

All in all, some of the rhetoric about the current Greek debt crisis appears to be overblown. This is not another global financial crisis and it is small scale in relative terms. Markets can be expected to soon adjust and we do not intend to make any major portfolio changes at this time.

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