



Greek sovereign debt crisis

The increased uncertainty over the economic outlook, rising level of debt and doubts over Greece's ability to finance its ongoing debt requirement, led to the European Union (EU) and International Monetary Fund (IMF) announcing a joint rescue package on 25 March 2010. Whilst the headline details of this loan were outlined, key details such as the exact size, cost and term were missing, resulting in nervousness in financial markets.

The uncertainty continued to build in early April, with the four largest banks in Greece requesting access to the remaining €17 billion from the state support package established in 2008, followed by downgrades to Greece's sovereign debt.

On 22 April, Greece's fiscal deficit was upwardly revised to 13.6% of its GDP - the 4th such revision in the last year; uncertainty prevailed once again and markets reacted accordingly. Greek government bonds were heavily sold and the euro hit an 11 month low versus the US dollar as foreign exchange investors took a flight to safety (source: FT, April 2010). These events led to Greece formally requesting the aid proposed by the EU/IMF earlier in the month.

Speculation began to spread that this rescue package was not nearly large enough to meet Greece's near term financing requirements and ratings agency Standard & Poor's was next in line to downgrade Greece's debt, this time to 'junk' status (BB+), reflecting the heightened status of the debt crisis.

Confidence continued to diminish in Greek sovereign debt to such an extent that their government bond yields moved around 8% higher than UK gilts, reflecting the increased risk, until news that EU ministers and the IMF had taken unprecedented steps to help. Loans of €110 billion were approved to avert sovereign default in return for Greece's commitment to a €24 billion austerity package, or spending cuts, targeted at reducing the budget deficit from 13.6% to less than 3% by 2014.

Crisis averted?

The immediate prospect of default has been averted. However, market reaction to the €110 billion international rescue package was muted on concerns that such extreme belt tightening raises doubts over Greece's economic growth and does not completely eliminate the prospect of future defaults.

The €110 billion of loans will meet the bulk of Greece's financing needs over the next three years, but confidence will still need to be regained if future government debt issues are to become a viable source of finance once again.

The challenge ahead for Greece is tackling the tough targets in the austerity package, without several of the tools usually required to help boost growth. Monetary policy remains loose and therefore has limited use as a stimulus; the membership of the euro-zone removes the possibility of deflating the currency to boost investment from overseas; global growth is unlikely to be sufficient enough to drag Greece along with it. Alongside the economic risks is the political risk that the Greek government will back down in the face of civil unrest including a series of general strikes and riots.

Nevertheless, whilst uncertainty remains, the important first steps have been taken to ensure financing is in place to enable Greece to function and the hope is that the fear of a country defaulting has been nipped in the bud.

Risk of ‘contagion’?

Whilst Greece is a relatively small player in the global economy, accounting for just 3% of euro-zone GDP in 2009 (source: Capital Economics, April 2010), it is seen as an advanced economy through its membership of the euro-zone. No member states have previously defaulted on government debt and this is still a highly unlikely outcome as Greece’s EU partners will try to find a solution to protect the euro-zone.

A sizeable budget deficit is not unique to Greece. Other European nations, albeit to a lesser extent, have problems of their own. Portugal and Spain recently suffered a downgrade to their respective credit ratings, whilst Ireland, Italy and the United Kingdom are all under pressure to reduce their deficit. The delays and indecisiveness with which the rescue package for Greece was put together has led to fears that, should other indebted euro-zone nations require funding of their own, this could result in a similarly divisive process across the member states.

Pressure is on for the majority of countries to reduce deficits, secure credit ratings, ease market tensions, whilst balancing spending cuts and tax increases with the recessionary pressures that linger. Should the cuts be too extreme, then recovery could be a lengthy process with governments having limited capability to provide further monetary stimulus.

Undoubtedly, any further signs of contagion, particularly sharp jumps in sovereign debt yields, would place pressure on the majority of asset classes – equities, bonds, commodities, currency, loan capital included, but the picture is not all doom and gloom: the majority of major economies have exited recession, reaffirmed by the US economy growing at an annualised rate of 3.2% in the first quarter of this year; economic recovery continues to take hold in the developing world, highlighted by Australia’s tightening of interest rates following significant demand for its raw-materials from emerging economies; consumer and business confidence has been returning; banks are better capitalised than they have been in recent years; corporate earnings have, for the most part, exceeded expectations – contributing to the FTSE 100 rallying by 15% from early February to mid-April.

Whilst the situation in Greece is clearly of significance, news stories ebb and flow, reaffirming the inability of investors and commentators to correctly guess the direction of market movements over the short-term. What does look more certain is that we are set for an extended period of fiscal tightening in the majority of European countries that should see interest rates remaining low for the foreseeable future, meaning that alternative sources of income will remain important. As does the need for a skilful investment manager to identify the companies that will benefit from those International and Emerging economies that continue to see growth.