Retirewell eNewsletter

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Greece: Tragedy or Farce? Either Way, Don't Worry

The Short Version: The current fear being generated by the Greek financial crisis is overblown. A Greek exit from the Eurozone is unlikely – the risks are too great for Greece and for Europe.

The Background

Greek debt levels came to the world's attention in December 2009, when credit ratings agency Fitch downgraded the nation's credit rating. Greece has had insufficient government revenue due to widespread tax evasion, which has been going on for ages. It was revealed that the government had been understating its true debt position for years. In an effort to avoid bankruptcy, Greece accepted bailouts from the "Troika" (International Monetary Fund, European Central Bank and European Commission) totalling more than €240 billion. These

bailouts were granted subject to harsh austerity measures that required an overhaul of the Greek economy. Reforming the economy and austerity measures have been enormously unpopular within Greece, resulting in three changes of Government since 2012. Greece now owes nearly €330 billion in total debt, which is equivalent to an unsustainable 170% of GDP (Gross Domestic Product, which is the annual value of goods and services produced by a country).

The Current Situation

Greece has become a tragedy of its own making. Greece has wasted 5 years not fixing the issues which beset its economy (reforming the tax system, selling assets, boosting growth and so on). Relations between Europe and the Syriza party, which was only founded in 2014, have been difficult. Syriza is a coalition of 13 disparate groups including Socialists, Maoists, Trotskyist, Marxist/Leninist, radical environmentalists, Euro-sceptics, Social Democrats, feminists and anarchist anti-capitalists. They are bound by their rejection of austerity measures and hostility towards the Troika – and little else.

The anti-austerity Greek Government, led by Prime Minister Alexis Tsipras, has dug in against the Troika's demands to implement extra spending cuts and economic reforms. To protect its financial system from collapse, on Monday Greece shut its stock market, closed its banks and enforced capital controls to prevent a run on its banks. Unemployment is running at 25%.

Unlike other Euro countries (Spain, Italy, Ireland and Portugal) which got into significant difficulties after the Global Financial Crisis and have since undertaken many difficult and unpopular changes, Greece and its politicians have displayed a complete lack of willpower to undertake the reforms that are absolutely necessary to get their country back on track.

Limited Contagion Likely

Despite the knee-jerk fall in global and Australian share markets over the last few days, we are of the view that there will be limited financial contagion no matter what happens in the next saga of this long unfolding Greek farce.

Greece is a small country of only 11 million people. The GDP of Greece is only 0.39% of the world economy and only 1.8% of the European Union's aggregate. If this current calamity had occurred 2 years ago there could have been major systemic financial risks created by a run on the entire European banking system. However, European banks have since cut their exposures to Greece and now only have € 5 billion of exposure, out of their total balance sheet value of €32 trillion, which means little or no systemic risk. Nor does the level of foreign bank exposure to the Greek financial system pose a risk. According to the Bank for International Settlements, the current exposure level is 85% less than in 2009.

Greece is now largely financially "ring fenced" with most of its debt having been transferred onto the books of various governments (mainly Germany and France), the IMF and the European Central Bank. Only around 13% of the country's government bonds are held privately. The ECB, through various measures and devices, has built firewalls around Greece's financial predicament - so unless the markets are badly mistaken, this is containable and not necessarily a systemic problem for the global economy.
The major risk is actually negative media headlines, beating up market fear.

Greek Referendum Next Sunday

Last Friday Greece unilaterally called off negotiations with its creditors. Greece has missed the €1.6 billion IMF payment which was due on Tuesday and is now in default – the first

Western economy to do so. Tsipras asked for a 2 year bailout program just before the deadline – but it failed to include any economic reform measures and proposed a restructuring of its crushing debt load. The plan was rejected.

Tsipras has called for a referendum on Sunday, 5 July, to allow the Greek people to vote on whether to accept the austerity demands of the Troika in return for further bailout funds. In reality, this will be a vote by the Greeks as to whether they wish to stay within the Eurozone. Tsipras is now campaigning hard for a NO vote, but the reality is that at least 70% of Greeks wish to remain within the Eurozone – the bank closures this week will likely give the Greeks a taste of what it's like outside. Presumably Tsipras called the referendum in order to go over the heads of his party, Syriza, which is threatening to revolt against his concessions to the European negotiators. The Greek Government doesn't have a mandate to leave the Eurozone – it wasn't elected on a Greek exit (Grexit) platform. The feeling among Greece's newspaper editors is that Tsipras has made a huge mistake in calling the referendum.

What is Likely to Happen

Trying to forecast what occurs in Greece is most likely a fool's errand and it is even harder to forecast the impact any outcome on markets, but there are some more likely scenarios than others.

- The chance of a Grexit is probably low. It's not a simple case of Greece failing to pay its creditors and then being forced to leave the Euro – no nation can be forced out of the Euro area, nor can it just simply leave. It would take months, if not years, to sort through the necessary legislative changes that the Greek government would have to make. Unlikely, given that they can't even agree on an acceptable bailout package. Syriza doesn't have a mandate for a Grexit, even on a NO vote. The logistics of trying to issue a new currency and the difficulty Tsipras would have paying wages and pensions in the interim, make a surge in social unrest and the removal of Syriza from government more likely than an actual exit from the Eurozone.

- Both Greece and Europe have much more to lose from a fracturing of the European Union than both are prepared to admit. Europe would strongly prefer no exit by Greece, which is fraught with unknowns and opens the exit door for other members.

- It's likely that the majority of Greeks will vote YES because they don't want their Euros to turn into devalued Drachmas. This will silence the dissenters in Tsipras' Syriza Party. With this outcome, Tsipras will be able to give the Troika what they want next week and save Greece from default and exit. It is also quite possible that after this outcome, the Tsipras government will have little political legitimacy left and will either fall, with new elections held, or be forced to form a government of national unity. Time will tell – what the referendum is unlikely to do though, is force Greece to exit the Eurozone.

The Future – Larger Bailout Needed

Whatever emerges from negotiations over the next week aimed at averting a Greek default and possible exit from the Eurozone, one can't get away from the fact that Greece is likely to be reliant on the support of the European Union and International Monetary Fund for years to come because of the depth of its economic malaise and its ballooning debt. While markets are currently focused on the €1.6 billion loan repayment to the IMF and the €7.2 billion bailout loan which needs to be approved to avoid default, there will need to be a third large bailout program negotiated later this year, totalling around €50 billion. This program will have to be centred on decade-long loans with ultra-low interest rates, so that Greece's current

primary Budget surplus can be used for debt repayments instead of interest payments. If this can be agreed, “the can will be kicked down the road” a little further.

Implications for Financial Markets

The uncertainty about Greece is primarily affecting bond, share and currency markets.

Shares - Uncertainty leads to volatility in the short term and all markets are experiencing this due to risk aversion. There has been a sell-off in Greek bank shares along with other European shares viewed as risky, in favour of other areas such as US and Australia.

Bonds - Greek bonds have already collapsed, but are likely to fall further into distressed/default territory. Prices for German bonds may be driven up by a ‘flight to safety’ out of riskier European assets as investors fear further disruption in the Eurozone. Australian bonds may also benefit from movement to safer assets.

Currency - the Euro has been relatively resilient to date – however some global investors may move to the US dollar as a safe haven.

What You Need to Do

Stick to your strategy. We see this as a distraction and just another market correction – albeit a little larger than most. It would not be sensible to sell out of growth assets now, particularly if they are invested within your agreed long-term Risk Profile. Seasoned investors with spare cash will view the current market weakness as a buying opportunity.

If you have any queries or concerns regarding your financial situation, please contact your Retirewell Adviser.

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