

THE GREEK TRAGEDY

Recent European Developments....

Wednesday, 12th May 2010

- The developments in European financial markets has led to extraordinary changes in the markets' outlook for interest rates and the valuation of the Australian dollar, which is trading at around US89 cents, down from US93 cents at the beginning of May.
- Concerns about the Euro zone have centred around the risks of contagion for the global banking system, rather than growth prospects for the region. As US Federal Reserve Chairman Bernanke explained to US senators last night, the Fed reopened its currency swap lines because Europe's problems could have hit US banks if left unattended.
- The announcement of the EUR750bn package over the weekend helped calm markets, although Euro zone countries face challenges introducing austerity measures as evidenced by civil unrest in Greece. The constraining impact on economic growth, of these measures, will be compounded by the inability of individual countries to devalue the currency.
- The ECB's intention to purchase government bonds may fall short of requirements, due to the need to sterilise all purchases, to contain the build up in bank reserves. Any easing of this requirement could pressure the Euro.
- Australia's strong fiscal position indicates how well placed Australia is relative to the troubled Euro zone countries, which have high levels of government debt. However, higher levels of total debt in Australia, and Australia's reliance on offshore markets for funding, indicates vulnerability to market contagion and the resulting widening of credit spreads.

The developments in European financial markets led to extraordinary changes in the markets' outlook for interest rates and valuation of the Australian dollar. Reasons were essentially not driven by weakening expectations for growth prospects in the Mediterranean region but by the risk of contagion to the global banking system. These forces are reminiscent of similar fears, which gripped the global markets during 2007 and 2008.

The announcement of the EUR750bn European package over the weekend has helped calm markets. An intention announced by the ECB to purchase government bonds is also welcome but may fall way short of requirements due to the apparent need to sterilise all purchases to contain the build up in bank reserves. Any slippage of that constraint would be a clear signal for the Euro to weaken as we saw other currencies weaken when central banks introduced quantitative easing.

Essentially, banks were aware of the huge potential write downs which investors in sub-prime related paper were likely to incur and became nervous about lending to other banks without a clear understanding of each banks' exposures. Action by the US Federal Reserve in purchasing around US\$1.4tr in asset backed securities for its own balance sheet helped settle spreads and provided banks with much needed liquidity which had in the past been provided through a freely operating banking system. The introduction of the stress testing process which allowed an independent assessment of the vulnerability of banks' balance sheets to ongoing economic stress was also important.

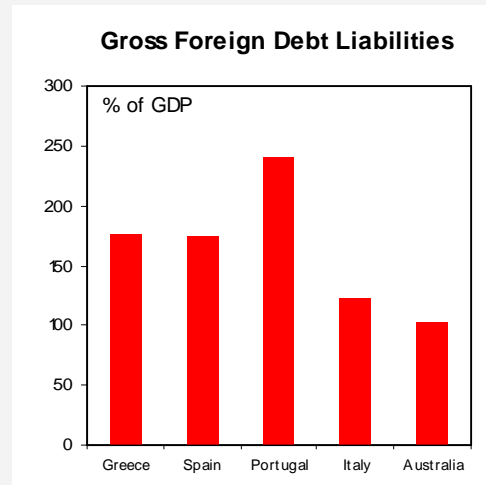
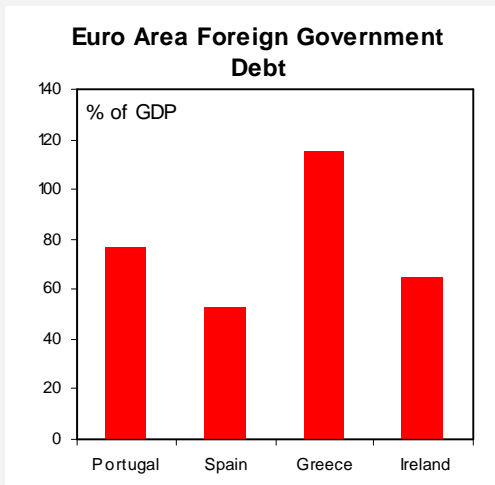
The challenge for the European Central Bank (ECB) is to sustain the settling of the global bond markets by taking a lead from the Fed's aggressive balance sheet expansion during 2007 and 2008. The task could be huge. The total bonds on issue for Greece, Spain, Portugal and Ireland is US\$1,255bn. These total volumes are broadly comparable with total bond issuance of the major economies. Clearly nothing like the full bond issuance by these countries would need to be purchased but the comparison with the Fed's activities in 2007 and 2008 shows that such action is feasible.

This action is a clearly distinct issue from funds being available to allow these countries to finance ongoing budget deficits and roll over maturing bonds. It will clearly be difficult for each country to issue new bonds into the market at affordable rates. Greece's budget deficit was 13.7% of GDP in 2009 and it is "projected" to contract to 3.5% of GDP in 4 years. Those numbers look extremely ambitious with the civil response to the austerity packages indicating the difficulties that all these countries are likely to encounter. The Stability fund is unlikely to be used to deal with the contagion problem associated with bonds that have already been issued.

Active buying of sovereign bonds by the ECB would settle market nerves; lower market spreads; reduce

potential huge mark-to-market losses for the banks and, arguably assist in the smooth issuance of more debt. Timidity by the ECB to purchase sovereign bonds on a large scale due to the need to sterilise purchases will prolong the contagion risks and threaten the global recovery.

The Federal Budget demonstrates just how well Australia is placed in the current environment; Australia's fiscal position is far superior to other developed economies let alone those of Southern Europe. However market contagion is still a huge risk for Australia given our high level of reliance on global capital markets to fund our foreign liabilities. The second chart below compares our foreign liabilities as a proportion of GDP with some of the European "villains". We rank with some of those economies that have lost the confidence of global investors. Market contagion and the resulting widening of credit spreads could be extremely costly to the Australian economy. Despite our success with our government's fiscal position we are still reliant on well functioning global capital markets.



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