

Economics Report

1 March 2010

Caton's Corner March 2010

Greece is the word

When I wrote last month, share markets had had a poor beginning to the year. I looked at some of the reasons, most notable concerns about China and Greece, and concluded that none of them seemed important enough to derail the ongoing world recovery. Hence they were unlikely to foreshadow the end of the share-market rally. There is a box on my desk labelled "Forecasts that are not wrong yet", and last month's forecast has been placed in the box. Most importantly, there is no evidence of any slowdown in China, while the issue with Greek debt is being addressed, albeit slowly.

Because of its problems, Greece has to pay an interest rate on its long-term government debt about 320 basis points (3.2%) higher than the German long-term bond rate. And it has a good deal of debt to "roll over" in March and April. Hence the reason why concern has arisen at this time. My view is that a combination of (possibly long-lasting) fiscal austerity, some help from other EU members, and IMF aid if necessary will keep Greece from default and inside the euro. In order to receive help from inside the Union, Greece apparently has to demonstrate some fiscal progress to its European Union partners by 16 March, which seems quite a short time horizon. Details available to date suggest that the Greek plan rests primarily, in the short run, on lifting the level of compliance in the payment of tax.

Greece needs desperately to reduce its central government deficit, which is currently around 12.7% of its GDP. One of Greece's problems is that the level of direct taxes (on income) is very low, in part because of widespread tax evasion. In 2008, direct taxes came to just 7.7% of GDP, compared with 12.2% for the Euro area as a whole. It also pays a relatively high share of GDP (11.5%) in public-sector compensation. Greece also already benefits from the kindness of other members of the European Union; its receipts from the EU budget minus its contributions come to 2.6% of GDP.

The IMF also will only provide aid with strings attached. If the Greek situation can be resolved, the chance of "contagion" (difficulties in financing the debts of other countries) will be limited. The rest of the PIIGS (Portugal, Ireland, Iceland, Greece and Spain) will honk a sigh of relief.

For the month, the US share market increased in value by 2.9%, while the ASX200 increased by 1.5%. For the year to date, the US market is down by 1% and the Australian market by 4.9%.

The Reserve Bank passed up a chance to raise interest rates again in early February, and it is close to line ball whether or not it moves in early March (you may already know!). It is not done yet, however. The Australian economy is doing so well that it no longer needs artificially low rates. Indeed, RBA Governor Glenn Stevens, with remarkable candour, said that there were two to four more increases (of 25 basis points each) in the pipeline for the rest of this year.

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The Bank typified its February decision (to do nothing) as “finely balanced”, while the Governor said later that the Reserve Bank Board had decided to “spend that month having a little look at how things are travelling”. The Board would have observed that there is more travelling being done to and from work; employment has now increased by 195,000 in just five months, while the unemployment rate now stands at just 5.3%, down from a peak of 5.8%. It would also have observed continued improvement in the level of confidence of both consumers and business.

While Australia may be raising rates, the United States is a long way from doing so. That economy is doing better than expected, although it was so battered at the trough of the recession that even several years’ growth will leave it weak. The recession cost it 8.4 million jobs and counting (employment lags growth, so it doesn’t begin to improve until some months after the recovery starts). The plight of the labour market has been so dire that there are now fewer people with jobs in the US than there were in September 1999! In Australia, we have increased employment by 24% in the same interval. Should one therefore be surprised that the Australian share market, up 64.6% since end-September 1999) has outperformed the US market, which is down by 13.9% in the same period?

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