September 2011

The debt crisis – not our problem?

Snapshot

Australian investors watching the recent market turmoil may feel like innocent bystanders caught in the crossfire of the sovereign debt battles in the USA and Europe. Our own debt has a AAA rating, so how can it be our problem?

The answer lies in one magic word — global. Government or sovereign debt tends to involve the world's big players. With the exception of Japan, which services most of its national debt by borrowing from its own citizens, most countries issue government bonds which are bought by other countries, foreign banks, and investment funds.

The debt web

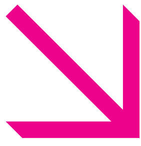
China holds over $1.1 trillion, or a third of its foreign exchange holdings in US Treasuries or bonds, partly to manage its exchange rate and keep its exports competitive. Japan also has a significant stake in US bonds. In Europe, the French are owed over $500 billion by Italy, while Spain owes both Germany and France over $200 billion. And so it goes on.

It's a giant global web, which gives the system strength while it remains in balance. But when a major link weakens or even fails, it all threatens to come apart. It is this fear which is currently hurting the world markets.

The worst case scenario is that a country may default on its loans. Or it may be de-rated, as Greece was, meaning it has to pay higher interest on its borrowings.

Debt can be reduced by raising taxes, cutting government spending, or both. Each requires strong political will. Improved economic growth has a major role to play but that is hard to achieve when austerity and fear dominate. And a quick fix by manipulating the value of the local currency is not possible for countries in the eurozone because they have a common currency.

Snapshot



Paying the interest

The rate of interest paid by countries on their government-issued bonds is influenced by the rating agencies which rate each country, and also by the market response to new bond issues. The highest and best rating, AAA, means the borrower country pays a lower rate than a AA+ rated country, as it is considered to be lower risk Australia, Sweden, Germany, and until recently the US, are countries which enjoy the AAA rating.

As the debt builds up in any country, so does the interest bill, which then reduces the amount of money available for expenditure on things like schools, hospitals and major infrastructure. In the USA, the debt burden more than doubled from $6 trillion in 2004 to $14 trillion in 2011. This led to a political arm wrestle in early August as the US Congress battled over a further increase to the debt ceiling, and how to pay it back via spending cuts or tax increases.

With Europe already struggling to find a solution to the problems of Greece and the much larger economies of Spain and Italy, the decision by Standard & Poor's to drop their rating on the US from AAA to AA+ became the specific trigger for the current crisis in world markets. The re-rating of the US placed even more pressure on the Euro countries, which had just brokered a fragile solution to the debt problems of their weakest member countries.

But why us?

But where does Australia come into this? Let's go back to that key word, 'global'. The web of debt funding is built on fundamental undertakings to pay back what you borrow, and so is the world banking system. The dominant fear is this latest debt crisis would set off a GFC Mk 2, with credit markets frozen again, which would affect our banking system and its ability to offer credit to businesses and households.

Fortunately, the world is better prepared and has reacted quickly this time but not always well enough to calm the markets. For example, the US Federal Reserve Bank announced it will keep interest rates near zero in order to prevent a credit freeze, and the G7 countries and the key European players are planning rescue packages for the eurozone.

Share market reactions have been swift and powerful, with steep falls followed by rises, then more falls. The emergency brakes seem to have been applied to the rollercoaster, but it is still running and it may take many years for the US and Europe to get their debt under control and pay it off. Neither the world — nor Australia — is out of the woods yet.

In Australia's case, our close economic alliance with China will continue to shelter us from many of these woes, but in the twenty-first century we are part of a global market place so cannot escape them completely.

What does 'sovereign debt' mean?

In simple terms it refers to borrowings by a national government against securities issued by the Treasury of the same government. Unlike personal or mortgage loans, there is no security or collateral involved, just the creditworthiness of a country, expressed as a credit rating. The better the credit rating, the lower the interest rate the country has to pay.

Avant
FINANCIAL SERVICES

Avant Financial Services
PO Box 585
Maylands
WA 6931

P 08 6102 1025
F 08 6555 8181
E admin@avantfinancial.com.au
W www.avantfinancial.com.au

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