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Faraway, So Close: How the Euro Crisis Affects Australia

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The European financial crisis has kept markets busy for the past three years. Yet Australians are still unaware what the European troubles mean for them. Is what is happening in Europe a regional phenomenon only affecting the Europeans themselves? Or are there implications for Australia despite its distance from the epicentre of the crisis?

This report argues that in a globalised world, there are no local crises anymore and therefore Australia should expect the European crisis to have an impact on its economic situation and performance over the coming years, if not decades.

Although Australia cannot influence events in Europe, it can prepare for the effects: limited exposure to potential sovereign defaults; increasing difficulties in accessing international capital at a time when European investors are withdrawing from global markets to shore up their domestic operations; and a slowdown of Chinese exports to Europe, which will have an impact on Chinese demand for Australian commodities.

To counter these effects, the only action Australia can take is to shore up its domestic savings or reduce its funding needs, for example, by returning the budget to surplus.

Beyond the expected negative consequences of the European crisis, there are two positive side-effects for Australia. Fire sales of Australian or Asian assets held by European financial institutions are a good opportunity for Australian investors to buy. Australia may also benefit from rising unemployment in Europe as many young, well-qualified Europeans are considering migrating to Australia. Australia could benefit from their skills and qualifications without having financially contributed to their education.

Beyond these direct effects of the European crisis, Australians could learn from the long-term consequences of ever-expanding government activity propelled by debt-finance in Europe.

In all of these ways, the European crisis may be both a challenge and an opportunity for Australia.

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Introduction[1]

The past two decades have been a time of tumultuous change for the world economy. The initial optimism after the end of communism in Eastern Europe, the opening of China, and the further integration of global commerce thanks to rapid technological progress was dashed after the 9/11 attacks and the end of the dotcom boom at the turn of the century. Despite these shocks, the process of globalisation, and the integration of the world economy, continued to open up trade opportunities, dampen inflation, and develop the economies of some of the poorest parts of the world. The interconnectedness of trade and commerce around the globe was seen as a blessing—and it certainly was.

In the past five years, however, the risks attached with the blessing of deeper economic integration have emerged. The *global* financial crisis—ironically called so only in Australia, where it is also abbreviated to GFC—has proven to be the flipside of globalisation. In an interconnected world economy, where benefits are shared by everyone, downturns and risks are making themselves felt in places far away from the sources of uncertainty. In a globalised world, any major crisis is almost by definition a global crisis.

In previous times, a housing downturn in parts of the United States would have been a domestic problem only for the US economy. Today, the bursting of the US subprime bubble triggered worldwide turmoil. The housing crisis, which began in 2007 in US mortgage markets, spread to financial institutions; led to the collapse of investment bank Lehman Brothers in 2008; and finally plunged most of the developed countries, particularly in the northern hemisphere, into recession in 2009.

As investors became alerted to the previously neglected importance of risk, they began looking closely at the financial viability of sovereigns. And when Greek Prime Minister George Papandreou admitted that his country had serious economic problems,[1] he inadvertently triggered the crisis in Europe, which has since spread from Greece to other countries. Portugal and Ireland both needed financial assistance, and most other European nations have had their credit ratings downgraded or at least put on negative outlook.

Seen from Australia, these events may not only appear to be far away but even make Australians feel better about themselves. Australia's public debt burden is among the smallest in the developed world. Australia's banks are in much better shape than their counterparts in Europe and North America. Last but not least, the mining boom has provided a boost to the economy at the very time that other economies are painfully trying to recalibrate towards new business models.

Europe is no longer as important to Australia as it once was.

So in assessing the impact of the economic crisis, whose epicentre now firmly lies in Europe, Australians may be unsure what to make of these events. Europe is no longer as important to Australia as it once was, and Australia's economic focus has shifted to Asia. But does this mean Australians can ignore Europe's downturn? Or will the repercussions of the 'euro quake' be felt in Australia as well?

A separate matter is of the lessons that can be learnt from Europe's crisis. Some of the problems Europeans are experiencing are certainly unique to them, for example, the result of a monetary union between vastly different economies. But European problems like funding a welfare state for an ageing society have already reared their ugly heads in Australia.

This report will examine some of the issues Australia is facing in the wake of the euro crisis. Europe may be half a world away but in a globalised world, distance offers only limited protection against the fallouts of major economic disasters. For its own welfare, and of future generations, Australia better prepare to face the likely tremors emanating from Europe's woes. We may be powerless against the European crisis, but we *can* protect ourselves from it—and perhaps even gain from it.

Limited direct exposure of Australian financial institutions

A major concern in the European debt crisis is the interrelation between sovereign debt and the banking sector. In the past few decades, European banks have been major sources of funding to the countries that are now struggling to service their debt burdens. A sovereign default would severely devalue these banks and may even obliterate them.

Australian banks, on the other hand, have never been greatly involved in the business of lending to European governments. Therefore, the direct fallout on Australia of any European government defaulting on its debt would be limited.

In a speech in October 2011, Malcolm Edey, Assistant Governor of the Reserve Bank of Australia (RBA) said:

> Australian banks have only limited direct exposures to sovereign debt in the countries that are most at risk. So potential effects on Australian banks' overall asset quality are not an issue.[2]

The direct fallout on Australia of any European government defaulting on its debt would be limited.

According to the RBA, the total exposure of Australian banks to Europe was $87.2 billion at the end of 2011 (2.7% of their assets).[3] However, even this figure overstates the risk from Europe's public debt crisis because the majority of this sum is invested in the healthier core of Europe (Germany, the Netherlands, and France): $74.6 billion is loaned mainly to the banking sector of these countries.[4]

Even in a worst case scenario, in which a number of countries in the European periphery default on their debt, Australia's banks may not be severely affected in a direct way. It would need a collapse of Europe's banking system for Australian banks to feel direct losses from their European assets. Even then, the total sums in question are not substantial and could be dealt with by Australia's banks.

Funding difficulties for Australian banks

Just because Australian banks have not been in the business of lending to European governments does not mean the Australian financial sector will be immune from the crisis. It is not only about the banks lending to Europe but our banks borrowing on international capital markets.

Australia has for a long time been dependent on importing capital. According to the RBA, Australian financial institutions had offshore borrowings of just $40 billion in January 1990, $123.5 billion in January 2000, and $314 billion in January 2012.[5] In the context of the financial crisis, such reliance on international capital is considered a weakness. Consequently, ratings agencies Fitch and Standard & Poor's recently downgraded the ratings of Australia's major banks with reference to their dependence on international markets to fund their lending.[6]

As the Australian economy continues to perform relatively well compared to other developed economies, its hunger for capital is likely to continue. Some industry experts like National Australia Bank CEO Cameron Clyne even believe that Australian banks' annual borrowing needs may double over the next decade.[7] Whether this happens depends on many different factors, not the least being the development of domestic house prices (that is where roughly half of the banks' lending currently goes). However, what is relatively clear is that a continuation of the financial uncertainty in Europe will affect Australia's offshore funding.

The transmission mechanism by which the European financial crisis will reach Australia is simple. As European investors are struggling to absorb the impact of the losses they incur in Europe, say from a potential sovereign default, they will be forced to pool their resources in Europe.[8] They will have to withdraw from other markets and liquidate their overseas assets to strengthen their home business. This process of deleveraging will pull capital out of countries like Australia instead of being made available to Australian financial institutions.

This development is already underway. The Bank for International Settlements (i.e. the central bank of central banks) recently reported that in the third quarter of 2011, European banks had already pulled investments worth $7.5 billion out of Australia to deal with their domestic funding squeeze.[9] French bank BNP Paribas, for example, sold about a third of its Australian assets.

The fire sale of assets held by European banks may not be entirely damaging for Australian investors looking for a bargain. It is usually beneficial to buy from someone who feels under pressure to sell; it is thus unsurprising that ANZ, for example, has indicated it may be looking at the Asian assets being put on the market by European banks.[10] However, despite such sweeteners the withdrawal of European capital from other parts of the world is bad news for the Australian economy as long as we remain so dependent on foreign capital.

Australian banks can do very little to affect this situation directly. They cannot influence the course of the European debt crisis, nor can they stop the Europeans from refocusing on their home markets. The only option for Australian banks is to reduce their dependence on offshore funding by increasing their Australian deposit-taking. Indeed, this process started at the beginning of the financial crisis, and there is now a high degree of competition for Australian savers' money. Interest rates available on high-yielding online savings accounts and term deposits show that banks are prepared to reduce their international vulnerability by courting Australian depositors.

When businesses and households depend on offshore funding, the government at least should aim to cut its own dependence on debt finance.

This development leads directly to another consequence of the European funding freeze. As capital supply ebbs away but capital demand remains high, the price of capital will increase and put an upward pressure on Australian interest rates. It is likely that interest rates will be higher than they would have been without Europe's crisis—and have a dampening effect on the Australian economy. It will also put constraints on the RBA's monetary policy. In recent times, it has not been clear whether the RBA effectively sets interest rates or whether its monetary policy simply follows the market.

So the European debt crisis may not directly affect Australian banks that are unlikely to incur any substantial losses in case of sovereign defaults in Europe. However, the indirect consequences are severe enough. Unfortunately, not much can be done to cushion Australia from the fallout of the European financial crisis but for one exception: The government can reduce the demand for additional funding by reducing its deficits and returning the budget to surplus. This would strengthen Australia's position in international capital markets. When businesses and households depend on offshore funding, the government at least should aim to cut its own dependence on debt finance.

Chinese slowdown, commodity prices

Another indirect way in which Europe's troubles may reach Australia is via China. It is no exaggeration to say that much of Australia's recent economic performance has been driven by China's economic development and its hunger for resources.

This story is well known. What is less obvious is what this has to do with Europe.

In developing its economy, China has been pursuing an export-led growth model, which only recently began moving towards a greater role for domestic consumption in China. Using a weak currency to propel its external competitiveness, the Chinese have become the world's largest exporter, even overtaking the traditional number one export nation Germany. Since 2010, Europe has been China's largest trading partner, leaving the United States behind.[11]

For Australia, this means a part of its commodities that are shipped to China do not end up in China but go through manufacturing and end up as consumer goods on the European market. As Europe slows down economically, China's capacity to continue its export-led growth model will no longer be viable. The Chinese know this and have made considerable efforts to redirect their business model towards the domestic economy—hence, the massive stimulus spending throughout the financial crisis on infrastructure projects and urban growth.

How much a struggling Eurozone country can cut back its Chinese imports was demonstrated last year by Italy: In 2011, Italian imports from China fell by 18%.[12] Such substantial trade reductions are painful even for a large economy like China.

There is another way the euro crisis harms China. As the Chinese yuan is pegged to the US dollar, it has appreciated against the weakening euro, damaging China's competitiveness vis-à-vis Europe and further slowed its exports.

The effects of China's stuttering exports to Europe are indirectly passed to Australia in two ways. First, the sheer volume of commodity exports will not rise as fast as it would have otherwise. To be clear, exports to China are still rising overall because the ongoing urbanisation of China requires vast amounts of coal and steel. However, there is also a dampening effect from the decline in Chinese exports.

The second effect of the weakening European demand for Chinese products will be on commodity prices. If the euro crisis reaches a new peak and plunges the continent into another severe recession, it is likely this will also manifest itself in falling commodity prices. For Australia, as one of the world's leading commodity exporters, this would reduce the favourable terms-of-trade it has enjoyed over the past decade. Imports would become relatively more expensive than imports, hurting the Australian economy as a whole.

Both effects are apparent in China's industrial production, which has been falling for the past two years, and its iron prices.[13] This is a worrying development for the Australian economy, which is so dependent on China as a customer for its iron ore exports.

Just as in the case of exposure of Australian banks, there is very little Australia can do to avoid its China conundrum. If European demand slows, if European imports and Chinese exports collapse, and if commodity prices take a dive, policy options for Australia will be limited. However, in such a scenario a fall in the Australian dollar would at least boost Australian exports the same way it did earlier on in the global financial crisis.

As Europe slows down economically, China's capacity to continue its export-led growth model will no longer be viable.

Flight to Aussie dollar safety? Loss of competitiveness

Whether the Aussie dollar will cushion the Australian economy from international economic downturns is not certain. In fact, it may turn out to be the other way around.

Since 2008, the Australian dollar has remarkably appreciated against the euro. At the peak of the global financial crisis, in late 2008, AUD was trading for about 50 euro cents; it is now hovering around the 80 euro cents mark. This is a marked change over such a short period of time.

Two reasons explain AUD's strong performance. Where previously the Aussie dollar was seen as a proxy for risk, there is now a growing sentiment that in the troubled world of developed economies, Australia is one of the few remaining havens. For international investors wary of the state of Europe, the growth of US debt, and Japan's demographic time bomb, Australia looks like a comparatively reassuring place. By putting their money into Australia, they feel they can avoid the worst as Australia is far removed from the epicentres of the global financial crisis. However, this narrative collides somewhat with European investors liquidating their Australian assets in the course of their deleveraging activities.

The second reason for the Australian dollar's new strength is the differential between Australian and overseas interest rates and the carry trade this attracts. In the Eurozone, Japan, the United States and Britain, interest rates are close to zero—and often deep in negative territory when inflation is factored in.

Australia is different. The RBA's cash rate, though significantly cut at the beginning of the global financial crisis, is 4.25%. The difficulty in accessing offshore funding as described above adds further pressure to interest rates available for deposits in Australia. This makes Australia an attractive destination for overseas investors wishing to avoid being punished by near-zero interest rates, and in the case of the US dollar and the euro, collapsing exchange rates.

As this money flows into the Australian dollar, again in a way that counteracts the deleveraging outflows, it will add pressure on the Australian dollar to appreciate. As a result, the Aussie dollar may shoot well above parity with the US dollar and approach parity with the euro.

This strength of our currency is a mixed blessing. On the one hand, consumers benefit from having access to cheaper import goods (if price savings are passed on, which is by no means certain[14]). On the other hand, further rises of the dollar will add to the woes of those sectors of the economy suffering from a stronger currency: manufacturing, tourism and education. In short, all sectors that depend on exports (international tourism and educating international students are both exports in this sense) will be hit hard by a continued Aussie dollar rally.

Not only will this contribute further to the often deplored move towards a two-speed economy, in which mining thrives and everything else moves backwards. It will also continue the trend towards an economy that revolves around the mining industry. To be sure, it is right for an economy to focus on areas where it commands a comparative advantage. One should not nevertheless confuse this with a painless transition. There will be substantial changes and social dislocations.

The Aussie dollar may shoot well above parity with the US dollar and approach parity with the euro.

The euro crisis may push the Australian dollar up further, which will speed up sectoral change in the country, albeit indirectly. As with all the other effects of the euro crisis on Australia, we can do very little to prevent this. The RBA cannot just cut interest rates to weaken the Australian dollar, and direct interventions in foreign exchange markets seldom, if ever, produce lasting effects.

Australia should probably just accept these developments as they happen and try to accommodate them on the ground. This means some workers losing their jobs in industries that cannot compete in a high dollar framework and understanding which parts of manufacturing are still viable. In such a scenario, mass-produced consumer goods probably are not a part of the mix that Australia could still offer, but highly specialised niche products might well be.

Increasing requests to participate in IMF bailouts

One of the minor risks emanating from the European crisis is one that has received disproportionate attention in the media: Australia's contribution to the bailout packages for European countries administered by the International Monetary Fund (IMF).

To be sure, there are good reasons to be critical of the IMF's policies towards Greece and the Eurozone. It is far from certain whether the IMF's involvement made a positive contribution; nor is it obvious that the policies being pursued will work in the long term.

What is clear, however, is that Australia's exposure to the IMF's activities in Europe is limited. The IMF's total capital is about to be doubled to about $770 billion. Australia shoulders 1.36% of this capital, so the Australian share is equivalent to about $10.6 billion.[15]

This sounds like a substantial amount of money—and yet it is not quite what it seems. Australia's share of the IMF's capital is a theoretical figure. It is contributions that the IMF can call should it need it in the future, not a contribution that Australia had already made. In a global economic scenario that required such dramatic action, Australia's $10.6 billion contribution towards the IMF would be the least of our worries. Fortunately, such an event is rather unlikely.

What remains of Australia's commitment to the IMF are cash commitments of around $400 million—a small fraction of the capital guarantees. Even these cash sums are, for the time being at least, not acutely endangered by the euro crisis since the IMF enjoys privileges as a lender and may recover most of its lending to European crisis countries in any case.

In an ideal world, Australia would not want to have anything to do with the business of bailing out countries like Greece. However, the IMF should be understood more like an insurance company. None of the insured wants to pay for the accidents of other insured, and yet all insured do because they are afraid they might be next in line to need help.

The situation is similar with the IMF. Australia contributes to the IMF not because it feels a special obligation towards Greece but because it wants to stabilise the international economy (from which Australia benefits) and because it expects IMF assistance should it ever need it.

Considering this insurance aspect of the IMF, its increasing role in Greece may not be ideal, and from an Australian perspective, one may criticise IMF's policies—except we are talking about sums that the Australian economy can absorb.

Surge in European migration to Australia

It is hard to find anything positive about the developments in the crisis in Europe. They mean hardship for millions of Europeans; they are leading to renewed tensions between European countries; and they are threatening global financial stability.

Australian diplomatic missions from the crisis countries of Europe are reporting a rise in visa applications.

Yet even in such difficult times lie opportunities, especially for a country like Australia. Indeed, it would not be the first time that Australia indirectly benefitted from European misery.

After World War II, Australia experienced a large wave of 'New Australian' migrants from continental Europe. Today, their descendants are almost indistinguishable from those with British ancestors. They may still have Greek or Italian names, and the colour of their hair and skin may be somewhat darker than of those who can trace their roots to Glasgow or Dublin, but the differences usually end there. The grandchildren of the 'New Australians' are as Australian as everyone else.[16]

The crisis Europe is going through is of course different from the immediate post-War period. But now, just as it was then, there are large numbers of Europeans who cannot see a prosperous future for themselves by staying in Europe. This is hardly surprising considering youth unemployment is far into the double digits and occasionally as high as 50% in the PIGS nations.

These young Europeans are often well educated and willing to work. However, even those lucky enough to find a job often work in precarious conditions. In Italy, it is not uncommon for academics to live with their parents well into their mid-30s because they cannot afford a flat of their own on their meagre salaries.[17] In Portugal, there is talk of a lost generation that moves from one internship to another without any realistic chance of finding full-time, permanent employment.[18]

For these people, intercontinental migration is now looking like an ever more appealing prospect—just as it had been to their grandparents' generation. There are reports of increasing interest in living and working in Australia, and Australian diplomatic missions from the crisis countries of Europe are reporting a rise in visa applications. Five hundred people attended an Australian skills fair in Athens in October 2011—yet 12,000 had applied for a ticket.[19] It is the same story in Ireland: Between June 2010 and June 2011, the number of Irish people who received an Australian visa increased by 50% to 21,784, according to the Department of Immigration and Citizenship.[20]

In Australia these developments have not been sufficiently noticed—and if they receive attention at all, it is only as a potential problem in the context of the deplorably populist 'Big Australia' debate. This is most unfortunate because Australia may be missing out on an opportunity even greater than bringing in the wave of the 'New Australians' in the 1940s and 1950s.

There is one crucial difference between the previous wave of European migrants and today's surge of interest in leaving Europe for Australia. Previous migrants came from war-torn Europe; they were glad to be alive and had little formal qualifications to offer but made up for this with a strong will to improve themselves through hard work. Today's migrants may be equally desperate to improve their fate by relocating to Australia, but they are much better qualified to do so than their predecessors. Nearly every young European nowadays speaks English, which was not the case with previous European migrants. Even now, there are some 'New Australian' migrants in Australia, who after all these decades, have a limited grasp of the English language.

The general level of education of the latest wave of European migrants is also much higher, with even university graduates finding it hard to find good jobs in the periphery countries of Europe and far from ideal job market conditions in the more prosperous core of Eurozone countries like Germany and the Netherlands.

Recently, the case of a university professor of chemistry created a stir in Germany because he complained that his annual salary of approximately $64,000 was grossly inappropriate for his qualifications. Arguing that even secondary school teachers easily earned more than a fully qualified university professor, he (successfully) sued his employer, the state of Hesse.[21] If he is lucky, he will eventually get a few thousand euros more as a result of his win in court.

If people like him moved to Australia, it would be a win for both sides. Australia would gain a qualified scientist towards whose education Australian would not have paid a single cent. Meanwhile, the scientist himself would definitely improve his personal situation by applying his skills in Australia, either as a university professor or working elsewhere.

For Australia, where there are skills shortages reported in parts of the country and some industries, and where the unemployment rate is around 5%, there should be a serious discussion about exploring the opportunity of tapping into Europe's pool of young, qualified and underemployed. These European migrants would be easy to integrate socially in Australia, which despite its multi-ethnicity, is still largely shaped by its Western tradition. Plus they would bring with them a desire to improve themselves, which makes them desirable migrants in any society. Rather than let other attractive migration destinations like the United States, Canada, or even (in the case of the Portuguese) Brazil benefit from this stream of migrants, Australia should try to attract these young Europeans.

European migrants would be easy to integrate socially in Australia, which despite its multi-ethnicity, is still largely shaped by its Western tradition.

An immaterial benefit: Learning from Europe's mistakes

In looking at Europe, Australia may well see its own future. In some ways, Australia is just 20 or 30 years behind the developments in the Old Continent. Australia's population is also ageing, albeit starting from a younger level. Australian governments have recently relapsed into financing their massive public spending increases on borrowing, just as European governments did in the 1970s and 1980s. And Australian government programs now sound as least as ambitious as European Union initiatives—and they will probably end up at least as wasteful and inefficient.

The European public debt crisis is a wake-up call to those who believe in running a country on ever more feel-good programs, welfare initiatives, and industry assistance. The crisis of Europe is a crisis of government that has become too big. This is where the massive debt burdens originate—only a small component of government debt is the result of the financial crisis. The financial crisis did not cause Europe's problems. It only made them apparent.

Perhaps this is the greatest benefit to Australia from Europe's current woes. Europe provides us with a clear warning. It shows us what happens when government spending grows continually faster than government revenue. Such a scheme of financing government ultimately becomes a Ponzi scheme when eventually more debt needs to be raised to just pay the interest on previous borrowing.

Australian politicians keen to implement their next flagship policy should be sent on a mandatory field trip to Greece or Portugal each time they want to spend extra money (or maybe not, since both countries are still nice places to visit as tourists). The lessons from Europe's decades-long spending binge need to be learned and understood. Australian governments should refrain from adding any extra programs to existing spending commitments for as long as the budget remains in deficit. Not only would this ease Australia's dependence on offshore funding but it would also reduce our vulnerability to global economic shocks and prevent us from edging closer to a situation similar to the one in which Greece, Portugal, Spain and other European countries find themselves.

The lessons from Europe's decades-long spending binge need to be learned and understood.

Conclusion

The world economy has become a much more integrated place in recent decades. On the positive side, this means the opportunities available to Australians are infinitely larger than just a generation or two ago. On the negative side, it means Australia cannot afford to ignore or brush off negative developments happening overseas, even in places as far away as Europe.

There are numerous transmission mechanisms by which the European debt crisis can and will reach Australia. Unfortunately, none of them can be stopped by actions taken in Australia. But we can take action to deal with the fallout from Europe's troubles. The most important ways to do this are by:

- reducing dependence on offshore funding by cutting the budget deficit
- providing transitional assistance where sectoral change happens in the Australian economy (without slowing down this—largely unavoidable—change)
- ensuring that Australian banks remain well regulated and strongly capitalised to be able to absorb shocks emanating from international markets, and
- opening our borders to qualified migrants from Europe.

Above all, Australians should strive to understand what has been happening to Europe. If Europe is not to become the blueprint for Australia's future, Australia must ensure that Europe's mistakes in public finance are not repeated in Australia.

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