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MONEY WISE

COULD THE EUROZONE CRISIS AFFECT YOU?

The chances are it already has! We now live in a global village and we cannot escape the consequences when something goes wrong in another part of the village. The challenge to us is what, if anything, we can do about it.

How did the problem come about?

You may recall last week I talked about credit cards and how their misuse could bring about a person's financial downfall. There is a close analogy where countries are concerned. Let's imagine every country has been issued with a credit card. Some countries have used it responsibly. An example is Norway, a country which always pays its debts on time and has carefully built up its savings. It enjoys an unemployment rate below 3% and its people enjoy a comfortable, but not lavish, lifestyle. Other countries on the other hand have abused their 'credit cards' and run up huge debts through their uncontrolled spending. The biggest offender is the US whose national debt is now running close to $16 trillion or $50,000 for every citizen. (Check www.usdebtclock.org to see a fascinating real time display.) But the US has massive resources and enjoys the privilege of being able to pull in funds from all over the world, particularly the Middle East and China, to enable it to remain solvent.

But Europe is a different story

Greece, one of the smallest economies in Europe, is not so fortunate. It has seriously overspent in relation to its size and is now relying on its neighbours to help meet its daily needs while it tries to pay off its 'credit card'. If it were the only individual in the village in serious debt it would not be too bad. The problem is that its larger neighbours in the Eurozone, in particular Italy, Spain, Portugal and Ireland have also been overspending. Their more careful neighbours, Germany and France got together and proposed some strict austerity measures to reduce the debts but the people in those countries have not taken well to the hardships imposed on them. They have protested in the streets and even the French revolted and have elected a more left wing government. The result is a big question as to whether the Eurozone and even the Euro can survive. On June 17 the Greeks will be electing a new government. If the left wing wins as expected and rejects the austerity measures the country could be the first to exit the club. Its ‘credit card’ would be taken away. This is not the end of the story. The fear is that other countries will then go the same way.

Europe’s problem now becomes everyone’s problem

If countries in the Eurozone walk away from their debts other countries will be badly hit as their financial institutions have invested heavily in Europe and Europe is a big market for countries like China. If the problem can be restricted to Greece it is manageable but if other countries start to default we are looking at some serious repercussions for the global banking system. This would entail another credit crisis and a withdrawal of liquidity from the financial markets. Stock markets could fall further and emerging markets could see a flight of capital. We have already seen in Indonesia over the past few weeks millions of dollars being withdrawn from the Jakarta Stock Exchange and a fall in the Rupiah. This is no reflection on Indonesia but it cannot escape from being part of the global village.

So what can we do as individuals to avoid the storm?

First of all we don’t panic; the worst may not happen. Governments are aware of the consequences of a meltdown so they may come to a consensus after a bit of sabre-rattling and brinkmanship and formulate a compromise agreement that keeps the Eurozone intact. In such a situation markets are likely to rally and we could see a period of optimism and recovery. Those with ample cash reserves and who are prepared to take a risk in the short term could well make some quick profits by investing in markets when they are down as at present.

But we should also prepare for the worst in the same way as we take out insurance. Safe havens in times of crisis are strong currencies like the US Dollar, Japanese Yen and Swiss Franc. Gold is also a traditional haven in times of political or economic uncertainty.

Cashing in investments when the markets are gripped by fear is a natural reaction but one which usually ensures that the investor never makes any money. Human nature drives people to buy high and sell low. Little wonder so many people make no money in the stock markets, even though they undeniably rise over time.

Regular savings plans are one solution

One way to avoid the trap of buying high and selling low is to commit to a regular savings or retirement plan in which the same amount of money is invested every month, irrespective of what is happening in the stock markets. This results in cost averaging which entails the buying of more units or shares when the price is low and fewer when the price is high. One caveat though; once a regular plan has begun it is very important to maintain the commitment. Failure to do so can result in heavy losses through penalty charges so do not take out such a plan unless you are confident of maintaining it. You should always have ample cash reserves to ensure you never miss a payment.

Some basic precautions for adverse times

Keeping ample cash reserves is perhaps the most important principle to follow. If you should lose your job having cash can see you through and reduce the risk of getting into debt. Thousands of people failed to follow this principle in the US in the 2008 / 2009 credit crisis and lost their homes as a result.

Don't put all or most of your eggs in one investment basket. There are many attractive investment products that are not correlated with stock markets. Some are not as liquid however so that should be taken into account as well.

Until the impact of the Eurozone crisis is known this is probably not a good time to be making a major purchase that requires borrowing money. And it is not a good time to be running up credit card debt. If you do so you may end up like Greece and have your card taken away!

Colin Bloodworth

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