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Greece's sovereign-debt crunch

A very European crisis

The sorry state of Greece's public finances is a test not only for the country's policymakers but also for Europe's

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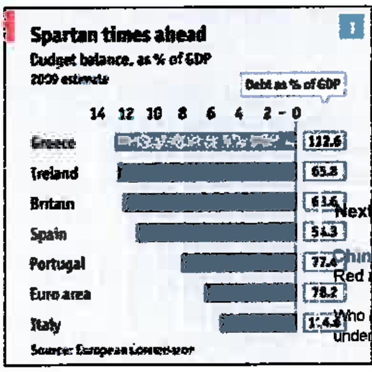
Illustration by Robert Venables

SOME would say that tragedy was inevitable from the moment, nine years ago last month, when Greece was admitted to the euro zone. Others would claim that woe was sure to befall such a disparate currency union sooner or later: if not Greece, then some other weak member of the club would have been the cause. Avoidable or not, trouble has arrived. At best, Greece has to undergo a dramatic budgetary tightening. Its fellow Europeans, or the IMF, may yet have to organise a humiliating bail-out. Some even talk—probably mistakenly—of the beginning of the end of the euro area.

Last year Greece's budget deficit reached 12.7% of GDP. Worries over whether the Greeks would act to cut it have caused paroxysms in the bond markets: late last month the yield on ten-year Greek government bonds vaulted to 7.1%, the highest since the country joined the euro area and about four percentage points more than that on German bunds, the euro zone's safest investment. The panic abated on February 3rd, when the European Commission endorsed the Greek government's plan to cut the deficit to 3% of GDP by 2012. The day before, Greece's prime minister, George Papandreou, had used a television address to announce higher taxes on fuel and an extension of a public-sector wage freeze to include low-paid civil servants.

However, Greece and Europe are not out of trouble yet. The commission says it will watch Greece closely to ensure that it keeps its promises: it expects a report in mid-March on Greece's chances of hitting this year's deficit target of 8.7% of GDP. Joaquín Almunia, the outgoing economics commissioner, said he hoped a positive assessment by the commission in mid-May would help restore confidence in Greece, which has one of the world's largest debt burdens relative to its GDP (see chart 1).



If the Greeks do not regain the markets' confidence, they may fail to refinance the €20 billion ($28 billion) or so of debt that falls due in April and May. At that point the government would default or would have to be bailed out. And Greece is not the only country about which the bond markets are worried. On the same day as the commission approved the Greek plans, investors were selling Portuguese bonds. The spread of ten-year bonds against bunds widened by 0.16 percentage points, to 1.43 points.

A marathon, not a sprint

Greece has a long history of fiscal trouble. It has spent half of the past two centuries in default, note Carmen Reinhart and Kenneth Rogoff in "This Time Is Different", a history of financial crises. When it became the 12th country to join the euro in 2001, its public debt was more than 100% of GDP. Many thought its chronic budgetary mismanagement might harm the currency.

For Greece, membership was a boon. Bond markets no longer had to worry about high inflation or devaluation. Lower interest rates allowed the government to refinance debt on more favourable terms: the ratio of net interest costs to GDP fell by 6.5 percentage points in the decade after 1995. The underpricing of default risk during the credit boom gave Greece easy access to longer-term borrowing. Lower interest rates also spurred a spending splurge. The economy grew by an average of 4% a year until 2008.

But strong GDP growth masked the underlying weakness of the public finances. The public-debt ratio fell, but only because GDP in cash terms grew more quickly than debt. Large budget deficits continued. Once it was safely inside the euro, indeed, Greece relaxed its fiscal grip. The primary budget balance (ie, excluding interest payments) was in surplus in the run-up to membership but has been in deficit since 2003. That did little to cool the economy. Greece's inflation rate stayed above the euro-area average, hurting its competitiveness. The economy relied increasingly on foreign borrowing. The current-account deficit widened to 14.6% of GDP in 2008.

If Greece had retained its own currency, trouble might have come sooner. But in the months after the collapse of Lehman Brothers, Greece was shielded by euro membership. It could still borrow easily, if not as cheaply, in bond markets even as investors' aversion to risky assets peaked last March. The economy was on course for a shallow recession at worst. Greek banks were free of the toxic mortgage securities that felled others. Forecasts for the 2009 budget deficit, at 5% of GDP, seemed almost modest compared with the gaping shortfalls projected for other countries.

Yet the reality was far worse, as became clear after October's election. The new government said the true deficit was likely to be 12.7% of GDP. Worse, the shortfall for 2008 was also revised up to include unpaid bills to medical suppliers. The mild downturn hurt tax revenues more than the previous administration had let on. The economy probably shrank by 1% last year, but consumer spending fell by more. Value-added taxes, a reliable source of revenue, were squeezed. Control of public spending had been relaxed in the run-up to the election, adding to the deficit.

Investors' trust in Greek statistics, never solid, was shattered. Two of the three main credit-rating agencies, Fitch and Standard & Poor's (S&P), cut their rating on Greek bonds and gave warning that a further downgrade was likely. A debt standstill by Dubai World, a state-backed property venture in the Middle East, made bond investors more nervous about sovereign risk. Greek bond spreads started to widen again. In mid-December the government responded with a fresh plan to cut the deficit. Bond markets were unconvinced. So were the rating agencies: Fitch and S&P cut Greece's grade again, from A- to BBB+.

On January 25th the Greek government enjoyed some brief reassurance, raising €8 billion in a sale of five-year bonds. The bank syndicate charged with placing the bonds said it had drummed up €25 billion-worth of orders in a matter of hours from investors attracted by an interest rate of 6.2%. Yet within a couple of days Greek bond yields were on the rise again. Stories that China had turned down an offer of Greek bonds—denied in both Athens and Beijing—also unsettled markets.

Predictably, Mr Papandreou blames speculators for the flare-up in the markets. But he also concedes that his country has been left vulnerable by its own profligacy. If the government wants to restore the bond markets' confidence, it will have to be bolder.

The planned cuts to the public-sector wage bill look small when set against such a

Olympic record
10-year government-bond spreads over

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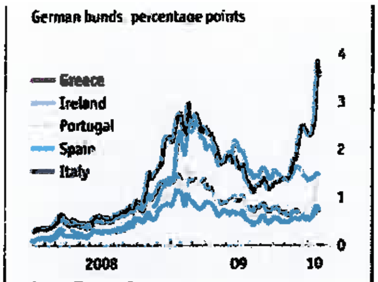
large budget deficit. They also look timid when compared with the much bolder action taken in Ireland, another cash-strapped euro member. In December the Irish government announced big reductions in civil servants' pay, only months after it had introduced a "pension levy" that cut public-sector wages by 7%. Its courage has been rewarded with lower borrowing costs (see chart 2).



Source: Thomson Reuters

Greece's finance minister, George Papaconstantinou, says the main problem in his country's civil service is overmanning, not excessive pay: the right approach is to slow recruitment and allow the payroll to shrink as civil servants retire. Fine, but time is not on his side. To appease Greece's jittery creditors a policy with speedier and more visible results is needed. A big pay cut in the public sector would help. Private firms might then find it easier to follow suit, which would help Greece to regain its cost competitiveness.

The government says it will present a plan for pension reform soon. Greece has one of the most generous, and therefore expensive, state pension systems among the 30 mostly rich OECD countries. Workers look forward to a pension of 96% of pre-retirement earnings. Greeks can no longer afford such a comfortable old age. In his television address Mr Papandreou hinted that a higher retirement age would be one plank of reform.

A bolder package of budget cuts might secure bond-market finance at tolerable interest rates. The Greek government says it has to strike a balance between budget cuts and keeping its "social partners" happy. But if it is too kind to public-sector workers, pensioners and so forth, it will struggle to find buyers for its bonds. If the bond markets are closed to Greece, the country will face bail-out or default. Neither option is likely to contribute much to social peace.

Which bucket to bail with?

The thought that Greece might fail to carry out the necessary budget cuts has had officials scratching their heads about the form a bail-out might take. When yields soared in late January, nervous Eurocrats were briefing journalists that a rescue package for Greece was being considered. The treaty governing the European Union includes a "no bail-out" clause, forbidding countries from assuming the debts of others. That clause was inserted in 1991, at the insistence of Germany, at the EU summit in Maastricht, the Dutch town where many of the ground rules for the euro were set down. Other treaty clauses, however, may allow for aid to an EU state in trouble.

One remedy would be for Greece to arrange a bridging loan from another euro-zone country in good credit, such as Germany. Such an arrangement may or may not be legal; it would certainly make for terrible politics. Voters in the donor country would be outraged if the rewards of their thrift were used to rescue the profligate. To ensure that good money was not thrown after bad, any loan would need to have conditions attached. That raises another problem. It is tricky for one country to tell another how to cut its budget. When Mexico was rescued in 1994, the Clinton administration at first wanted to manage the bail-out alone. It quickly realised that it would be better to have the IMF ask Mexico to sign up to conditions. For Mexico in the mid-1990s, read Greece today. "If Germany steps in, there will be people on the Athens street who will say the *Wehrmacht* is back," an economist remarks.

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Illustration by Robert Venables

European officials are privately horrified at the thought of calling in the IMF to bail Greece out. Pride is at stake. To turn to the fund for aid would be a humiliation for Europe, never mind the Greeks. The reputation of the euro is on the line and its members ought to be strong enough to fix problems within its borders. An IMF-led rescue would only underline the feebleness of the euro zone's procedures to prevent fiscal laxity, even if few outside Brussels and Frankfurt ever set much store by them. European officials also seem reluctant to accept that the euro is not a shield against all crises. The EU has been content to work with the IMF in helping Hungary, Latvia and Romania, but these countries are not yet in the euro.

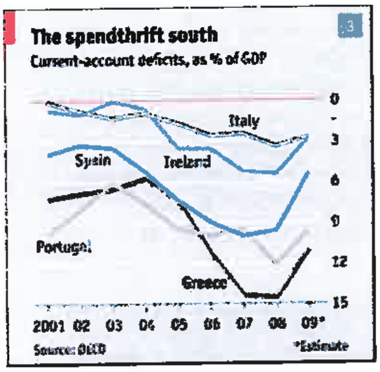
The trouble is, the euro area has no mechanism to help a member that cannot fund itself in capital markets. So default is all too plausible. If Europe is too proud to call on the IMF, it will have to come up with its own fund as a backstop for Greece, and quickly.

A template for such a fund already exists. The EU has a loan facility to help members outside the euro with balance-of-payments problems. The fund's ceiling was raised to €50 billion last spring, to cope with the potential need for emergency loans to Hungary and others. The facility is financed by EU-backed bonds, issued as the need arises. Loans for Greece could be raised in the same way, though it would mean that countries outside the euro, including Britain and Sweden, would be liable if they were not repaid. And the chances that Britain, determined to stay outside the single currency and short of money itself, would put itself on the hook for a bankrupt euro member seem slim— even if British pension and insurance funds hold a good slice of Greek debt.

In any case, a bail-out by Greece's partners is unlikely to be as effective in sorting out the country's finances as an IMF programme. To assuage the lenders' domestic voters, EU loans would have to be made at a punitive interest rate. The IMF, by contrast, would offer cheaper funds with stricter conditions. And it has the experienced staff the EU lacks to make sure a miscreant sticks to a plan to fix its finances.

There is an alternative to a bail-out within Europe or by the IMF: default. Mr Almunia has insisted that this will not happen. "In the euro area…default does not exist," he declared (perhaps rashly) on Bloomberg television. Yet there is a view that default may be less bad than a bail-out, especially a botched one. Greece's financial woes are a problem for the country and its creditors to sort out. If Greece has to declare a debt standstill, say the hardliners, so be it. Financial aid would only discourage countries from mending their finances. Concerns that this would undermine the euro's credibility may be misplaced. The countries that stand behind the rich world's other main currencies (the dollar, the yen and the pound) have troubles of their own. Indeed, the euro is suffering from a surfeit of credibility since, on many gauges, it is overvalued against the dollar.

Coming Acropolis



What makes default unpalatable is the fear of contagion—that if Greece were allowed to go under, the cost of borrowing for other troubled euro members would shoot up. (Banks holding troubled countries' bonds would also suffer.) Portugal, as the sell-off on February 3rd suggests, is next in line. Its public-debt ratio is 77% and rising. Its current-account deficit is almost as big as Greece's (see chart 3). Italy has public debt of a similar scale, relative to GDP, to Greece's; but its budget deficit is only half as big and its current-account deficit is relatively small. The Italian bond market is the world's third-largest. Such a large and liquid market is less vulnerable to speculati attack than a small one, such as Greece's or Portugal's. Ireland is small, too, but its government has shown itself willing to take unpopular decisions to right its public finances. The Irish economy is more flexible so its medium-term prospects seem brighter. The economy grew slightly in the third quarter of last year. There are even signs that tax revenues are recovering.

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The Greek crisis only confirms the folly of binding a group of disparate countries together in a currency zone with no mechanism, such as a central fiscal authority, to address its internal imbalances. The north-south divide in the euro area looks more marked than ever. The north, exemplified by Germany, relies on exports to power its growth, saves hard and runs trade surpluses. The southern economies, such as Greece, have leant too heavily on consumer spending, have weak public finances and rely on foreign capital to supplement their low savings.

Do these disparities, and the trouble in Greece, threaten the break-up of the euro, as some believe? European officials retort that large imbalances are found in all large currency areas—even the United States. Spain's construction bust and rigid labour markets seem certain to condemn it to years of economic struggle and high unemployment, yet Michigan is scarcely in better shape. The state's outlook is clouded by the long decline of Detroit's motor industry. Greece is struggling to raise funds, but so is California, which accounts for a far bigger share of America's output (one-eighth) than Greece does of the euro zone's (a bit more than one-fortieth).

An important difference in the case of the United States, however, is that the bulk of taxing and public spending is done by the federal government. As Marco Annunziata of UniCredit, an Italian bank, points out, California's debt amounts to less than 1% of America's GDP. Greek debt comes to 2% of the euro zone's GDP.

It is unlikely that Greece would be forced out of the euro, still less that it would choose to leave. Any hint of that would cause a bank run. A departing country may get a brief fillip from having a cheaper currency but it would still be left with expensive euro debt to service. Borrowing costs would shoot up to reflect higher currency and inflation risk. A more likely scenario than break-up is that the euro area finds ways around the absence of a central fiscal authority while stopping well short of a unified budget, for which there is scant political support.

A forthcoming paper from the Centre for European Policy Studies, a Brussels think-tank, sets out some ideas about how this could be done. The authors, Daniel Gros and Thomas Mayer, think the euro area should prepare for fiscal crises instead of trying only to prevent them. They propose an insurance system with premiums based on each country's debt and budget deficit. The money raised would be used for loans to euro members shut out of bond markets. If a bailed-out country failed to comply with the conditions attached to loans and threatened default, the fund would stand ready to swap the country's "bad" bonds, at a discount, for "good" bonds backed by euro-zone members, in order to limit the costs of contagion. "Only if default is possible can market discipline be maintained," say the authors.

Such a scheme would not obviate the need for deep reform in Greece. Successful companies complain that they are overtaxed to make up for evasion elsewhere. Small firms continue to operate below their efficient scale, because if they were bigger, they would attract the tax authorities. Greece's higher inflation is partly explained by a lack of competition in parts of the economy. As in Italy and Spain, wages are set centrally with too little regard for differences in productivity across industries and companies. If Greece is to get itself out of trouble, fixing the public finances is only the beginning.

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