The Greek Fiscal Crisis

By Dr. Kenneth Matziorinis
Canbek Economic Consultants Inc.

Why is Greece facing a fiscal crisis?

Greece has one of the highest debt-GDP ratios in the Eurozone (113%), one of the highest budget deficits (12.7% of GDP) and one of the highest foreign debt ratios of all the countries in the zone (gross debt of 150% of GDP). When the newly elected government of George Papandreou was elected last Fall, they shocked markets by reporting that the previous government of Constantine Karamanlis had left them with a much larger budget deficit that had previously been reported, so it obviously spooked markets and forced the question, is Greece solvent and will it meet its payments on its Euro 300 billion (CAD 450) public sector debt. Bond markets reacted immediately to the news and pushed up the risk premium demanded on Greek government debt to almost 400 basis points above the German bunds, the benchmark for the Eurozone. The cost of insuring Greek debt obligations in the form of credit default swaps (CDS) rose immediately and credit rating agencies such as Fitch, S&P and Moody's downgraded Greek government debt and placed them on negative watch, which implies further downgrades are in the pipeline unless the Greek government comes up with drastic measures to resolve the problem.

One of the issues that has compounded this problem is Greece's waning credibility in that it has underreported both its debt and GDP figures in the past and has a history of not adhering fully to the criteria imposed on the monetary union by the Maastricht Treaty. Also, Greece's economy has had chronic structural problems of an over-bloated public sector, burdensome bureaucracy and is not sufficiently competitive.

Are all of Greece's problems of it's own making?

Although Greece is largely responsible for its fiscal problem, there have also been factors external to the Greek economy. What have been these factors? First, the global financial crisis that broke out in 2008 and the global economic downturn that followed from it. Although the Greek banking sector remained sound and was not exposed to toxic assets as other European banks were, it affected the economy negatively especially through the impact it had on its trade in services. Tourism and maritime shipping are the two most important sources of income and both were badly hit by the global crisis. Second, part of the blame goes to the European Central Bank which in the early years of the millennium, kept interest rates lower than it should to accommodate the export-driven industrial part of the Euroeconomy, namely Germany, France and the Netherlands. By setting rates lower this benefited the Northern tier of the Eurozone but created lax monetary conditions for the Southern tier, this is why Greece, Portugal, Ireland, Spain and Italy, not to mention the non-Euro countries its Eastern periphery including Hungary and the Baltics. Third, the appreciation of the Euro from less than USD 1.00 to over USD 1.50 since 2003 has undermined its competitiveness and since it no longer controls the value of its currency as Canada or the UK can, has been forced into a straight-jacket.

Why has the Greek fiscal crisis made the top of world news, is Greece, economically that important?

No, Greece is not that important. It's economy accounts for less that 4% of the Eurozone economy and its total public debt is around Euro 300 billion, much less than the bailouts of Fannie Mae and Freddie Mac, AIG, Royal Bank of Scotland or Citicorp, to name only a few.

There are two reasons why Greece has become so important in the news. 1) Because it is the first stress-test case of the underlying stability of the European Monetary Union (EMU). When the EMU was formed and launched the common currency euro-skeptics argued that the European economy is too diverse to support a stable common currency. Moreover, unless countries agree to unite their fiscal policies and unify their public debts, a currency union will not last. Greece's situation now proves their point and raises the question: will this lead to a break-up of the EMU? Will Greece be forced out of the EMU and back to the Drachma? If so, this undermines the credibility of the Maastricht Treaty, the soundness of the EMU, the strength of the euro as an emerging reserve currency and questions the soundness of the Euro institutions and reduces Europe's status as a global economic and political power. 2) When most advanced industrial countries with large entitlement programs look at Greece's current fiscal woes they see themselves, one, two or three years down the road and this alarms them! Let us not forget that Italy and Spain (Eurozone's #3 and #4 largest economies, followed by Japan, the UK and the USA are not that far behind. When the bond market pays closer attention to what is happening in Greece, then they will start paying more attention to the growing fiscal problems of other countries that raises the question, who is next? *(we all hope it is not the behemoth).*

What has been the response of the Greek government so far?

The Greek government has drafted and started implementing a deficit reduction plan that aims to reduce Greece's budget deficit by 4% to 8.7% in 2010 and down to 3% by 2012. This plan was submitted to the European Commission in Brussels and was approved with reservations. Public sector wages were frozen, supplemental compensation cut by as much as 10%, short-term contracts cancelled, fuel taxes raised, among many other measures. Despite being the most draconian set of austerity measures applied in Greece in the post-war era, the austerity plan has failed to satisfy markets because of Greece's credibility gap. The Greek plan has been criticized for failing to introduce immediate cuts in public sector wages and government spending. Given the chronic nature of Greece's structural problems, the solution must also be structural in nature, and this requires more time to effectively implement, than the markets are willing to give Greece at this time. Thus despite these measures, markets have not only maintained pressure on Greece but the spreads of other South European nations' debt obligations have started to widen as well, indicating that Greece's situation had become 'contagious' and could spread to other eurozone members.

What has been the response of Brussels and the EU so far?

The European Commission and ECB have been forced to deal with a dilemma. If they act to bailout Greece, it creates a moral hazard problem where they reward the spendthrift member while asking the frugal members to pay for the consequences and this action risks undermining the credibility of the euro. If they don't, and Greece is forced to insolvency two other problems get created: 1) the crisis spreads to other EMU members such as Portugal, Spain and Italy in which case the whole EMU goes down and 2) most Greek debt is owed to German and French banks who would be forced to take a large haircut, not to mention that many of the issuers of credit default swaps are German financial institutions and they will be forced to pay out the insurance, very much as what happened with AIG when Lehman Brothers went down. What ultimately precipitated the global financial breakdown in 2008 was the US Treasury's refusal to bail out Lehman, and when that 'mistake' was done, world markets reacted in a panic and this brought down the whole financial house of cards. Brussels, the ECB and most of all Berlin are very mindful of what happened then and they do not wish a repeat of the same story a second time around, especially inside the Eurozone.

Thus, although the Maastricht Treaty and the present Euro institutions do not now allow for one member nation to take on the debt of the other, individual nations can still offer assistance on a bilateral basis should they choose to. One practical and relatively inexpensive way to do this is if countries such as Germany and France offer to guarantee some of the debts of the Greek government –especially those that are maturing over the next three months (approximately 45-50 billion euros) in order to buy time for the Greek government to implement it's austerity plan and regain some credibility in financial markets. This was successfully done in the 1990s by the Clinton administration in the US to help out Mexico, and the Mexican government bonds guaranteed by the USA are known as the "Brady bonds".

Moreover, since Greece is not the only country that is facing a public debt crisis in the eurozone, it would not be seen well nor be appropriate or fair to do so as a reactive measure to bail out one country. It would be better viewed as a pro-active step to reinforce existing and build new institutional mechanisms within the EMU to help all countries facing similar problems in the future.

On Thursday, February 11, 2010 European leaders met in Brussels and decided to stand together to defend the monetary union. EU President Mr. Van Rompuy told journalists that "Euro-area member states will take determined and coordinated action if needed in the euro area as a whole". Although details of the actions contemplated were not issued at today's meeting, the first step, which is the policy decision was made. On Monday, the Eurogroup –the council of euro-area finance ministers under the presidency of Jean-Claude Juncker- is meeting in Brussels to decide on the specifics, and at that time we should find out more about the nature of the measures contemplated by the EMU.

Will the measures taken by Greece succeed in cutting the deficit?

Greece's fiscal problems are largely the result of a historical legacy of relying too much on the government for job creation that dates back to the 19^{th} century following the creation of the Greek state. They were compounded in the 1980s by the populist measures of then Prime Minister Andreas Papandreou, whose socialist policies led to a massive increase in Greece's debt and printing money to hand out entitlements to the Greek population. An interesting aspect of this "Greek Tragedy" is that now the son (current PM George Papandreou) is being called upon to pay for his father's fiscal sins.

I believe that the austerity and structural reform measures that were announced by the Greek government will work, although they will need to be reinforced by additional actions and may take a little longer to complete. Why? For the following four reasons: 1) The fiscal problems have resulted from a lack of political will to initiate bold reforms and public resistance to correct the structural problems of the country. Although Greeks always complain and resist cutbacks in entitlements they are not fools, they know they are living beyond their means and they know that radical changes are necessary. This crisis has provided the catalyst to carry out all these reforms. 2) Greece will never risk leaving the monetary union because it has brought benefits such as low interest rates, economic stability, rising living standards and appreciation of assets that they have never enjoyed before. Income restraint for a few years as long as it involves structural reforms to safeguard these benefits is a good price to pay. 3) Greece needs its membership in the EU and the EMU as a matter of national security, in the face of an aggressive Turkey on their border. Public opinion polls show a greater than 60% approval of the actions taken by the Greek government so far and Prime Minister Papandreou's popularity rating has gone up, a surprise to the skeptics. The public union strike on Wednesday brought far less people on the streets of Athens than anybody expected while the farmers' blockades of highways have fizzled out due to lack of public support. The budget deficit in January 2010 came in 39% below that of January, 2009. 4) Greece's tax system is highly dysfunctional and inefficient while there is still a large underground economy in place. Rationalizing the tax system can bring huge new revenue to the government while rationalizing the state bureaucracy can save huge sums without resorting to salary cuts. Just an interesting point to note, there is effectively no property tax in Greece!

Will this crisis bring down the European currency union?

No. A United Europe is still a project under construction. This is one more challenge in its process of integration. In a global environment of super states like the USA, China and others, European states are too small to defend their interests and be counted. They very much need a strong and cohesive union, not only economic but also political and this crisis, far from leading to the break up of the common currency will actually provide the impetus for the further integration of the European states. They will either stand together or they will fall together! European integration is a one way street.

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