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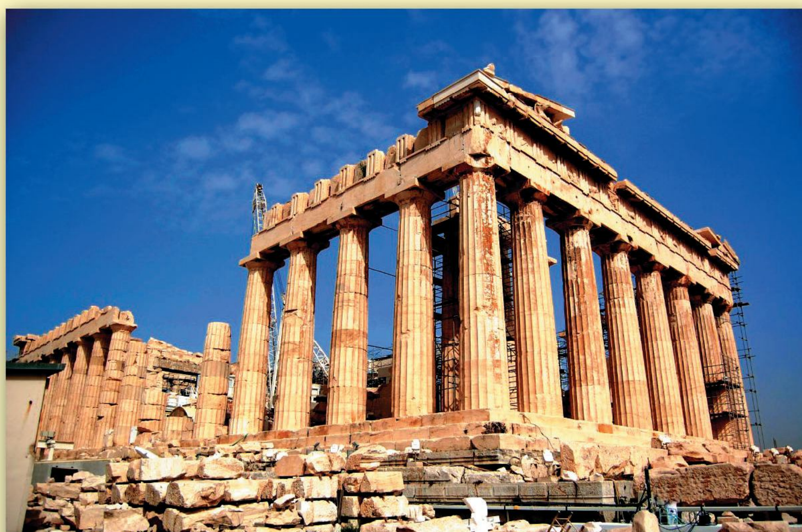

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Theme 222

SOVEREIGN DEBT CRISIS - THE GREEK EPISODE

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SIB STUDENTS' ECONOMIC FORUM

MAY 2010

Theme No. 222 : SOVEREIGN DEBT CRISIS – THE GREEK EPISODE

As the global economy was about to recover from the aftershocks of the financial crisis, another set of crises has emerged – the problem of sovereign debt crisis with the epicentre of the crisis being the southern region of European Union – starting with Greece. It is common for individuals, corporate entities and also for an entire segment of economy turning bankrupt, but what about countries themselves becoming bankrupt and unable to repay debts especially the external debt raised by them? In such situations, who is there to bail-out such defaulting countries? What are the remedies available to avoid insolvency of sovereign nations? This raises important questions about government managing its finances and the prudential regulations required for public finance or fiscal management.

What is sovereign debt crisis and how did it originate?

Sovereign debt crisis means sovereign governments' borrowing from domestic and external markets in excess of their capacity to repay, resulting in loan defaults requiring rescheduling of loans or bail-out packages from other countries or multilateral institutions such as IMF. The crisis surfaced when it became known that Greece cannot meet its repayment obligations to its external creditors. This is a unique case of a sovereign entity borrowing in excess of its capacity and raising debt domestically and externally to meet its expenditures. The budget deficit of Greece is in the range of 13.6 percent of its GDP. The stock of debt is equivalent to 115 percent of GDP. Greece has reached a critical point where it cannot meet its payment obligations without outside help. The euro-zone and the IMF have put together an ambitious package to help Greece. The package of support also requires Greece to put through a series of austerity measures. But there is a strong public resentment to such measures.

The debt problem is compounded by the fact that nearly three-fourth of the government debt is held by foreign institutions, particularly foreign banks. A default by Greece will have serious consequences for its economy. It will dry up all sources of external funding which will then weaken the economy further. The economic growth rate has stagnated and this compounds the debt servicing problem.

Not only the fiscal deficit was high in Greece, but the high fiscal deficit was hidden by derivatives hedging and it was not made known to the outside world. It is also suspected that investment banks played a role in misleading investors into investing in government bonds of Greece by not disclosing the actual state of affairs. The rating agencies failed to assess the correct fiscal position of Greece.

How do you compare the present crisis with the financial crisis emanated from the US?

The 2008 financial crisis was caused by the excesses of the financial institutions and financial markets. It can be regarded as the failure of the markets and the private sector. The private financial institutions, in their pursuit of profit, resorted to innovations and speculative transactions which became self-destructive and led to the collapse of the system. The current Greek episode has been triggered by the excesses of a public entity, which is the government of Greece itself. Thus the present crisis is the result of the 'government failure' as opposed to the 'market failure' as happened in the earlier financial crisis.

What are the lessons of the present fiscal crisis for the highly indebted economies?

There are several lessons to be learnt from the Greek episode. There is the need for all countries to maintain fiscal prudence – govt. spending and raising resources should be subject to prudential regulations. The fiscal deficit – the difference between resource actually raised and expenditure planned – should be contained to a level that is consistent with a country's ability to meet the debt service payments. It is proved wrong that by running high fiscal deficits – by borrowing internally or externally – a country can grow fast. It becomes more complex when a substantial part of the government debt is held by foreigners. Also public debt of a long term nature cannot be raised for meeting revenue expenditures. If the debt is deployed for productive purposes, the income that is generated will take care of the debt service burden. Otherwise debt accumulation will become a fiscal burden and will lead to the bankruptcy of the government treasury. The idea that public debt to GDP ratio should be appropriately maintained is a good lesson from the present crisis. In other words, the sustainability of public debt is an important issue to be considered.

The US is also having high fiscal deficit and the fiscal deficit of the US is also being financed by the foreign institutions including central banks holding US government bonds. But then the US dollar acts as the reserve currency and the US continues to attract investors. However, there are inherent dangers due to over-debt in the system. The US has high deficit in balance of payments also. But the US has much strength as a leading economy and can afford higher fiscal deficits and BoP imbalances. This may not work with relatively smaller economies such as Greece.

How will the sovereign debt crisis affect the EU as a single monetary and economic entity?

The European Union (EU) was a conglomerate of nations with different levels of development and productivity. However, they decided to go in for a common currency in the belief that differences will get over in course of time. But this did not happen. In the boom period, the differences and contradictions did not surface. But the economic recession aggravated the situation. The pursuit of a single monetary policy for the EU as a whole is making it difficult for smaller countries to make its own policies. A singly monetary policy with differing fiscal options will not be effective in continuing the economic union of nations. If the Greece had its own currency, it could have devalued the currency and thereby economic growth through increase in exports could have succeeded. Also this could at least partly offset external payments crisis. But this option is not available as a member of the monetary union. There were predictions about the chances of Greece and other debt-ridden economies exiting from the European Union to pursue their own monetary and fiscal policies to salvage the economies. But this is not found to be practical, as reinstating old national currencies in place of Euro and re-denominating the existing debt will be a very strenuous path. Now it is argued that Greece and other highly indebted countries (PIIGS – Portugal, Ireland, Italy, Greece, and Spain)should follow strict austerity measures to curtail government expenditure and bring down fiscal deficit. But one cannot go too far on austerity, as this may impact economic growth and subsequently the ability to service the debt. Anyhow, the severity of the present crisis calls for immediate action on reinstating fiscal prudence on the part of the governments.

The future of European Union as a single monetary and economic entity is cast under uncertainty. There are economic and political analysts who predict that the present crisis may lead to disintegration the EU. According to them, the attempt to establish a single currency for 16 separate and quite different countries is bound to fail. The individual countries would lose the ability to control monetary policy and interest rates and, more crucially, exchange rates to respond to national economic conditions. The present crisis may be overcome by bailout packages of the ECB and the IMF. But similar crises are to be expected in such an arrangement. Therefore, some mechanism of enhanced surveillance and control along with the resilience for mutual accommodation and adjustments are required for continuance of the common economic arrangement.

What are the implications of the sovereign debt crisis on the expansionary fiscal policies followed by the various governments?

When the financial crisis evolved into a global economic crisis resulting in economic slowdown or recession, the governments launched expansionary fiscal policy to boost the sagging demand in the economies. The fiscal deficits of the countries exceeded normal levels. Economic analysts started highlighting the significance of the doctrines of the famous economist, John Maynard Keynes, who is known as the 'father of deficit financing'. Deficit financing means spending by the government in excess of the revenues by resorting to borrowings or printing of new money. This method is being adopted by the developing economies for realizing faster economic development. Keynes' doctrine of deficit financing or pump-priming of money was recently pursued by the governments to overcome the financial turmoil and economic recession. The budget deficit in the US has expanded from 2.7 percent of GDP 2006 to 12.5 percent in 2009. In the UK, it went up from 2.7 percent to 11 percent. In India also, the aggregate fiscal deficit of the union and state governments reached nearly 12 percent of the GDP. But recent events in Greece and other southern European economies suggest that there should be reasonable limits to fiscal deficits and also that fiscal spending should be productively deployed. A more or less balanced budget appears to be the ideal solution in the longer term.

What will be the likely impact of the crisis on the Indian economy?

The impact of the Greek crisis on India depends on how quickly the euro-economies will handle the situation. If there is turmoil in the other European nations and the crisis is going to be prolonged, it may adversely affect India's trade and capital flows. It may end up with another global economic crisis resulting in what is termed as 'double-dip recession'. India should be cautious about fiscal deficits while targeting a high trajectory of economic growth.

IMF- EU Bail-out Package for Greece

Greece reached agreement with the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB) on a focused program to stabilize its economy with the support of a Euro 110 billion (about $145 billion) financing package. The Greek government is required to implement rigorous fiscal measures, far-reaching structural policies, and financial sector reforms. The following are the key elements of the reform package:

- **Fiscal policies will be adopted towards reduction of fiscal deficit** – Fiscal deficit should be brought down to 3 per cent of GDP by 2014 as against 13.6 in 2009-10.
- **Government spending should be curtailed** - Pensions and wages will be reduced or frozen for three years, with payment of bonuses of workers abolished, but with protection for the lowest-paid.
- **Government revenues should be raised** - Revenues measures include raising value-added tax, and taxes on luxury items.
- **Revenue administration and expenditure control** - The government will strengthen its tax collection and raise contributions from those who have not carried a fair share of the tax burden.
- **Financial stability** - A Financial Stability Fund is being set up to ensure a sound level of bank equity.
- **Entitlement programs** - Government entitlement programs will be curtailed and social security benefits will be cut while maintaining benefits for the most vulnerable.
- **Pension reform** - Comprehensive pension reform is proposed, by curtailing provisions for early retirement.
- **Structural policies** - Government to modernize public administration, strengthen labor markets and income policies, improve the business environment, and divest state enterprises.
- **Military spending** - The plan envisages a significant reduction in military expenditure during the reform period.

The Greek government says the nation faces "sacrifices" in a "choice of collapse or salvation" and the austerity measure are required to rebuild the economy.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in