The latest few weeks have seen a sizeable upswing in international financial strains. The Chinese government’s efforts to rein in credit growth have certainly helped to revive some investors’ concerns. But the most important development is the increase in market apprehension regarding sovereign debt (government bonds). The financial problems in Dubai and Greece’s lowered credit rating, combined with unfavourable outlooks for the debt of other European nations, focused the financial markets’ attention on the risk that some countries could be unable to pay their debts.

Efforts to prop up the financial system and cope with the global recession made government deficits explode worldwide (graph 1). The Organisation for Economic Co-operation and Development estimates that the 30 member nations’ combined deficits went from 1.3% of GDP in 2007 to 8.2% in 2009, increasing their gross debt from 73% to 90% of GDP. The surge in deficits was especially steep in the United States, the United Kingdom and some European countries. Certainly, a deterioration of this magnitude in the public finances will have major consequences. Our forecast for a moderate global economic recovery in the coming years, especially in industrialized countries, is partially based on the fact that public administrations will have to gradually reverse their support measures in order to rebalance their budgets. This will substantially restrain growth, an effect which will start to be felt as of 2011 at the latest.

The current problems are not surprising. Historically, banking crises are often followed by a substantial increase in public debt due to the costs of bailout programs and, in particular, to the drop in tax revenues as a result of the recession that usually follow. Carmen Reinhart and Ken Rogoff, two specialists on this topic, recently wrote in the Financial Times: “Unless this time is different—which so far has not been the case—yesterday’s financial crisis could easily morph into tomorrow’s government debt crisis.”

Concern blossomed recently, as there seems to be a growing likelihood that Greece will be unable to handle the payments on its debt. Some analysts are even suggesting the country could abandon the euro. The spread between Greek and German bonds and the cost of insuring against a Greek default have skyrocketed (graph 2 on page 2). Other euro zone nations grappling with similar problems, such as Spain and Portugal, were also affected, and Euroland’s currency has depreciated by more than 4% against the greenback since mid-January. This also prompted a flight to quality on international financial markets, making the stock indexes nosedive (graph 3 on page 2). Although many governments have undeniable budget problems, the question is whether these problems have the potential to plunge the financial system back into a wave of panic akin to the one that followed the Lehman Brothers bankruptcy.

**WHY IS GREECE MAKING THE WORLD NERVOUS?**

Greece’s economy is a small one and it does not play a major role in international financial markets. However, as one of the 16 members of the euro zone, its domestic problems have consequences for the stability of the common currency. Also,
as its debt is denominated in euros, Greece cannot use the money printer to pay back its creditors, which increases the possibility that it will one day be unable to pay them. Along with being a big blot on the European Union’s (an association of 27 countries of which the euro zone is a sub-sample) credibility, a default in Greece would make the markets speculate about which zone nation would be the next to run into major difficulties. The size of Greece’s debt—around €250B (US$350B)—also constitutes a substantial risk to the European banking system, which is still weakened by the recent financial crisis.

A number of euro zone nations, including Ireland, Spain and Portugal, are facing budget gridlock. However, the severity of the Greece situation is worsened by debt that is over 110% of GDP (graph 4) and a chronic credibility problem—it has been shown that the budget statistics provided by the Greek government in recent years were incorrect. As a result, the financial markets gave quite a sceptical reception to the recently announced efforts to get the deficit back under 3% of GDP in 2012 so as to meet the criteria of the Stability and Growth Pact; spreads between Greek and German bond rates have continued to widen (graph 5). Greece, which must issue over €50B (US$70B) in debt instruments in 2010, managed to make a major issue in the last few days; however, it had to pay a very high interest rate to attract buyers: 6.2% for a five-year term, compared with less than 3.5% in interest on a similar bond three months ago.

Unlike Iceland, Ireland and even, to a certain extent, the United Kingdom, Greece’s budget problems do not come from the financial crisis. Instead, they are directly related to the major structural problems that have sapped the country’s international competitiveness in the last decade. Rather than capitalize on the period of prosperity that followed its accession to the euro zone in 2001 to modernize its economy, the Greek government substantially increased its spending and made the size of the public sector balloon. Moreover, the major rigidities in Greece’s economy led to greater wage and consumer price increases than in the other euro zone nations. Foreign trade was hurt by the loss of productivity; today, Greece is in an untenable situation, with major budget and trade deficits.
WHAT OPTIONS FOR GREECE?

The current situation is untenable, as lenders will not allow Greece and other struggling European nations to continue to rack up substantial deficits. In theory, Greece cannot count on help from its economic partners, as European Union rules prevent one member nation from taking on another member’s debt. Dropping the euro would do nothing to solve Greece’s problems: the country would end up with debt denominated in a foreign currency in an even more difficult economic context. Both politically and legally, expelling Greece from the euro zone seems almost impossible. The only way out therefore appears to be massive budget reform that would quickly wipe out the deficits.

In practice, however, it will not be easy to get Greece’s public finances back into balance. To get its budget situation back into control, Greece could have to condemn itself to a long period of very weak economic growth and salary freezes. If the governments and people accept these sacrifices, Greece should gradually mend its budget situation and international competitiveness. Increasing government revenues, which are currently relatively low in Greece compared to other European countries, could be part of the solution (graph 6). However, there is a real risk of a popular outcry against such austerity that could convince Greek politicians to default on the debt and perhaps even drop the euro. Farmers and unions have already clearly expressed their opposition to the efforts the government announced. This would be catastrophic for Greece. In the current situation, the common currency is one of the only factors keeping Greece from tumbling into real financial chaos. While Greece’s financing costs have posted an impressive increase recently, this is nothing compared to what would happen after abandoning the euro.

For now, European institutions have decided to take a hard line on Greece and other countries that are grappling with a budget squeeze. The President of the European Central Bank has declared that the Bank would not be giving any special treatment to a country that is in difficulty, for example, by changing its collateral rules. Moreover, he clearly stated that, for Greece, the solution was not to get help from outside, but rather to make the necessary decisions, as Ireland is currently doing. The hypotheses that a country will decide to drop the euro, or that European institutions will give Greece a bailout are judged as absurd by European monetary authorities.

However, the fact is that there is a possibility that Greece will soon be unable to refinance its maturing debt. As a default by Greece would also slam the European Union’s credibility and could bring down other countries in the zone, European authorities will soon become more pragmatic. To prevent a catastrophe, the European institutions and other countries in the zone could give Greece some support, for example, by providing liquidity if the country were temporarily unable to get financing on the markets. Greece is not “too big to fail” but, for the euro zone, it is “too integrated to fail.”

A SERIOUS WARNING FOR THE GOVERNMENTS, BUT THE CATASTROPHE SHOULD BE PREVENTED

If Greece agrees to make the required efforts, the most likely scenario is that the country will get through this crisis but its economic performance will be affected. However, if the situation deteriorates further in the weeks to come, the zone’s pillars, European institutions and perhaps even the International Monetary Fund may have to step in to stabilize the situation. One thing is certain; it seems inevitable that, like Ireland, Greece and other zone members will be forced to institute painful budget reforms in the coming years, which will hamper their economic growth. Spain has already announced an austerity plan to keep from being speculators’ next target. On February 3, the European Commission will report on the possible need for more actions to slash the Greek deficit.

Recent events have, however, made the market aware of the risks associated with some countries’ excessive debt loads. However slight, there is a chance that one euro zone country
will sooner or later opt to default on its debt and, even if it seems economically irrational, drop the common currency. Other smaller countries elsewhere in the world could also have trouble meeting their financial obligations in the next few years. This uncertainty will continue to affect the markets in the coming months and could well keep financing premiums higher for a number of countries, a situation that could limit their economic growth. However, although there is a possibility of a lasting increase in sovereign risk, the probability is small that it will lead to a crisis like the one that followed the Lehman Brothers bankruptcy.

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