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Fiscal Crisis I:
A Greek default is not the answer

Allianz

Fiscal Crisis I: A Greek default is not the answer

In today's vibrant media world, quick and stark assessments are called for. One currently doing the rounds is that Greece will not be able to survive economically if it doesn't restructure its debt. Restructuring, by the way, means reducing debt – be it by cutting interest rates on government bonds, extending maturities or by enforcing an outright haircut - it all amounts to a lower net present value of the asset held by the creditors. One of the motives behind calls for a debt write-off is to make private investors shoulder some of the restructuring costs - be it savers, fundholders, institutional investors like pension funds and insurance companies, or, of course, hedge funds and banks. But at this point, it should be noted that debt waivers can hardly be enforced only on certain groups of creditors. So calling for debt waivers automatically pulls the taxpayer into the equation, because loans of European governments to Greece would also have to be written off partially. The first best solution for the taxpayer – and this sometimes seems to be forgotten – is if the situation in Greece is successfully stabilized and the debts, together with interest, are paid back in full.

So can Greece pull this off? The answer is yes. Even this crisis can be mastered by taking the right action, and taking it rigorously. There is no point in throwing in the towel before the measures put together by both the Greek government and the EU/IMF have even had time to take effect. Suggestive back-of-the envelope calculations which supposedly illustrate the impossibility of a solution do not help. What is needed is a differentiated analysis of the fiscal picture in Greece and the experiences of other countries in a similar predicament. Let's consider a few important points.

Budget consolidation is making headway

The reining in of the Greek budget deficit is proceeding somewhat quicker than planned. In the consolidation program agreed with the EU and the IMF, the estimate for this year's deficit was recently trimmed down to 8.1% of gross domestic product (GDP), coming from 13.6% last year. Greece might even manage to undershoot this target because, in the first four months of this year, Greece's deficit was already down by almost 42% (on a like-with-like basis, source: Greek Ministry of Finance) on last year. This success is owed to the fact that, even before the actual savings programs were imposed, the Greek government had already started to curb its spending – particularly on the investment front. If the agreed consolidation programs are implemented in full, Greece will achieve substantial savings in the second six months of the year, too. Even if we factor in the blow that a "stabilization recession" could potentially deal to the budget (growth in 2010: minus 4%, 2011: minus 2%), the deficit could more or less be halved this year to somewhere between 6% and 7% of GDP. This should go at least some way to restoring some of the trust that the capital markets have lost in Greek fiscal policy. Looking ahead to 2011, the consolidation program that has been drafted with the IMF and the EU envisages new borrowing to the tune of 7.6%. In our view this target is not ambitious enough. There is no sense in spreading the consolidation process (the pain) out over a period of several years, because an acute confidence crisis on the capital markets can only be overcome by achieving swift success with stringent consolidation measures. We believe that this is within Greece's grasp, not least as the country can now pursue tax debtors more successfully.

Interest rate on government debt still lower than prior to EMU entry

A popular argument is that Greece is destined to suffocate under the enormous public sector interest burden. This has to be put into perspective as well. The interest rates for government debt have been relatively modest in recent years: Last year, the country was paying an average interest rate of around 4.4% on its outstanding government debt (interest payments are based on the gross debt at the end of the year). This year, the rate is likely to climb to 4.8% before continuing to rise slightly over the next few years maybe (as also the EU assumes) to a rate of 5% by 2014. This level is still much lower than in 2000, when Greece was faced with an interest rate of around 7%. Seen from this perspective, the consolidation efforts would certainly not appear to be doomed to fail, even if the debt level rises to 130% of GDP in 2011.

Expressed as a proportion of GDP, the Greek government's interest payments will come in at around 5% to 5½% of GDP in 2009 and 2010 respectively. This is a relatively high figure by international standards, and it looks set to rise further in the coming quarters. Nevertheless, there are some examples of countries that manage to get by with interest burdens on this scale. Italy is one example, Brazil another. The South American country has more than once been on the brink of insolvency, but has managed to clock up notable progress over the past ten years thanks to an economic policy approach with a firm focus on stability and debt reduction. Thanks to moderate budget deficits, total government debt in Brazil was slashed from just over 86% in 2002 to below the 60% mark in 2007. Nobody is calling Brazil's solvency into question at the moment, although the country's interest burden has consistently been hovering around the 6% mark in recent years.

Greek status quo less dramatic than the Belgian predicament of 1995

Any attempts to dramatize the situation in Greece are questionable by way of comparison with Belgium in 1995. Across the board, Greece’s present debt indicators are less precarious than Belgium's in 1995. Belgium's interest payments accounted for 8.9% of its GDP, compared with "only" 5.4% in Greece this year. Also, in 1995, Belgium's interest expenditure equated to just shy of 17% of the budget, in Greece the figure will be around 11% this year. As the overview set out below shows, Belgium managed to achieve a marked improvement in its financial situation in the space of five years, between 1995 and 2000. So why shouldn't Greece be able to accomplish something similar, given that its starting position is not worse but somewhat better than Belgium`s back in 1995?

Public debt indicators

comparison between Greece and Belgium

Greece	1995	2000	2009	2010f
Interest expenditures in % of GDP	11.2	7.3	5.1	5.4
Interest expenditures in % of public spending	24.6	15.7	10.0	11.1
Public debt in % of GDP	97.0	103.4	115.1	124.9
Belgium	**1995**	**2000**	**2009**	**2010f**
Interest expenditures in % of GDP	8.9	6.6	3.7	3.8
Interest expenditures in % of public spending	16.9	13.4	6.8	7.0
Public debt in % of GDP	129.9	107.9	96.7	99.0

Source: EU Commission, spring 2010 . f = forecast.

Examples of successful debt reduction in developed countries

Also amongst highly developed countries there exist a host of examples in which debt-ridden countries have managed to dig their way out of a crisis and slash their government debt levels within a reasonable period of time: in Ireland's case e.g., by no less than 80 percentage points, from approximately 120% to less than 40% between 1987 and 2002, in Belgium's case by around 50 percentage points from 1993-2007, in the Netherlands by more than 30 percentage points from 1993-2007 and in Spain, also by in excess of 30 percentage points, from 1996-2007. And yet, these countries were not faced with the massive international political pressure`that is being exerted on Greece at the moment. And exchange rate adjustments in many cases were only minor.

Of course, additional problems would arise if the Greek economy were to enter a prolonged period of stagnation or negative growth. Admittedly, scenarios like this cannot be ruled out, but they do not tie in with the experience of many other countries, which managed to shake off a debt crisis and fight their way back to growth, in most cases fairly quickly, through stringent consolidation. Belgium, Ireland and Canada are only a few examples: while the Belgian economy spent three to four quarters locked in a recession before it started to grow again, Ireland and Canada were able to completely avoid economic decline in spite of far-reaching government consolidation measures. Maybe Greece really will fly in the face of everything that experience has taught us, but taking a scenario of failure and inevitable debt restructuring as the basic assumption for our actions is certainly not the ideal approach. It can always be argued that "this time is different", but this motto has proved to be a dangerous misfit for many other aspects of the current crisis.

Risks of a default from a European perspective

To round off the analysis so far undertaken from a Greek perspective, some warnings concerning the European implications of a Greek default seem necessary.

- Risk of a possible chain reaction. If Greece restructures its debt, the spreads for other debt-laden EMU countries would most likely widen again. The past few years provide ample evidence that the financial markets tend to act indiscriminately in uncertain times, and that capital takes a quick exit from all markets that are considered risky, irrespective of fundamental differences. A Greek bankruptcy would put other countries at risk, and recourse to the EUR 750bn rescue fund would then increase. The European taxpayer would have to pay the bill.

- A "haircut", i.e. a partial debt waiver, would not only hit European taxpayers directly, but also indirectly, because some of the continent's financial institutions would come under considerable pressure, possibly necessitating renewed government aid.

- A situation in which the banks are forced to carry the burden of any debt restructuring alone - an idea with a diverse range of followers – seems virtually impossible, because it violates the principle of equal treatment that applies to debt restructuring. No creditor can be put at an advantage or a disadvantage over another. Why, for example, should a bank with Greek bonds in its portfolio have to accept a 10% debt waiver, while a private individual with Greek bonds from the same tranche is not forced to waive any of his claims?

In summary: Greece's predicament is anything but a lost cause. It therefore does not make sense to rashly evoke the first-ever case of government insolvency in the euro area, with unforeseeable consequences for other member states and the quality of the euro as an investment currency per se. All efforts must be aimed at enabling Greece to service its debts in full, especially given the massive assistance of the international community. This is what Prime Minister Papandreaou has been announcing and we shouldn't try to prove him wrong.

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