

Greece

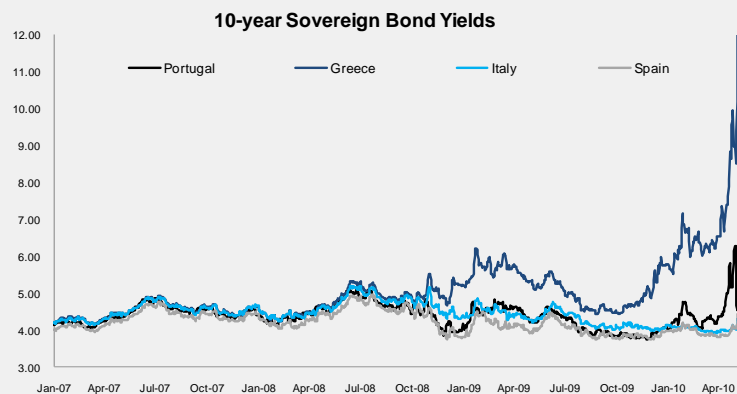
Fixed Interest and Credit Research

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In this paper we discuss intensifying sovereign risk concerns and the debt crisis in Greece, and possible options the Greek government may consider in solving its problems.

Sovereign risk concerns in Greece and other peripheral countries in Europe have intensified in the past few months. These countries' fiscal positions have deteriorated significantly during the Global Financial Crisis (GFC) and markets have started to question whether some of them would be able to refinance their government debt and find buyers for their bonds. Many of these countries had large budget deficits prior to the GFC. The unprecedented efforts to rescue their banking systems and respond to the sharp economic recession during the GFC have left their debt and deficit positions in unsustainable territory. The country in greatest difficulty is Greece.

A decade ago Greece entered the eurozone with relatively healthy public finances. However, it rapidly slid into deficit after entry, and has been running a deficit ever since, while borrowing relatively cheaply under eurozone interest rates. Greece's borrowing costs rose sharply in 2008 when the GFC magnified its poor fiscal position. Deteriorating budget deficit expectations and reports of its 'creative accounting' led to a loss in confidence causing Greek government debt yields and sovereign CDS spreads to rise sharply.



Source: Bloomberg

The risk of contagion to other eurozone member countries threatened to push the European banking system (that had a sizeable exposure to these countries) into yet another crisis. In April, after weeks of uncertainty, Greece finally asked for aid. The Greek government agreed to austerity measures set by the EU and IMF in order to receive a EUR 110bn bailout package. However, the long-awaited rescue package did not settle the markets' nerves due to its conditionality and lack of details. In an effort to prevent another liquidity crisis due to of rising uncertainty, European finance ministers outlined a 'stabilisation' package for a total of EUR 750bn on 10th May. This unprecedented package, together with the ECB's announcement that it would buy government bonds, has considerably reduced concerns over liquidity and contagion. However, solvency and restructuring issues over the medium term in Greece (and potentially other countries) remain a clear risk. Concerns that these factors will result in significantly slower economic growth have created further declines in the euro, global equity markets and other risk assets in the weeks since.

The key difference between Greece's situation and past occurrences of sovereign debt distress is that Greece does not have control over its currency and monetary policy. The ability to print money (and repay maturities), set interest rates (to stimulate the economy, control inflation, etc) and allow the exchange rate to depreciate are some of the tools that governments have historically used to manage the risks associated with debt distress.

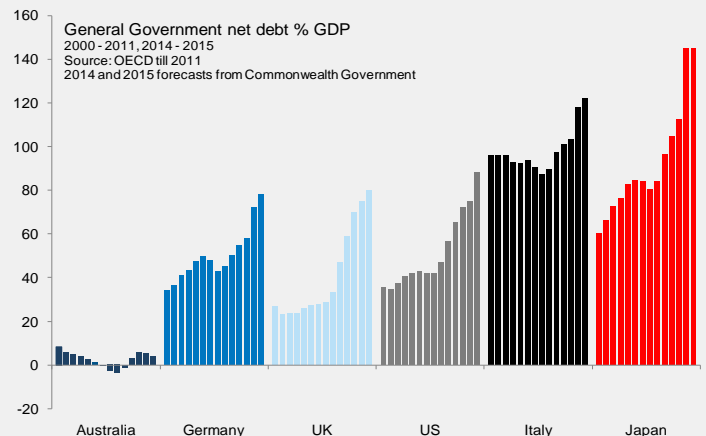
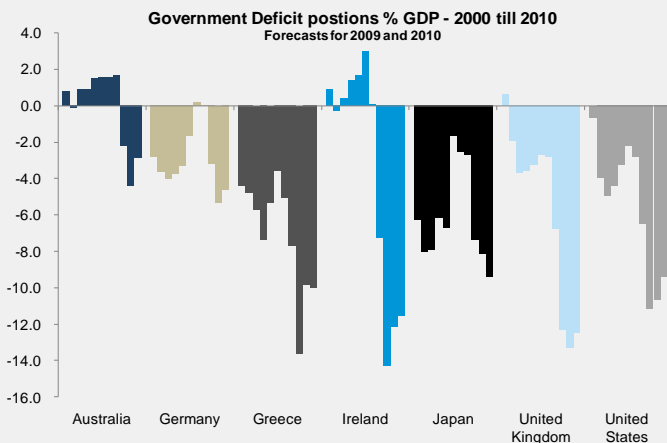
So what are the options?

We identify three main scenarios for Greece:

- 1) *Accept the austerity measures* in order to continue receiving funds from the EU/IMF. The measures implemented, however, could risk triggering a deep recession. Total outstanding debt would likely increase significantly, crippling future budgets and growth. Locking in slow growth and high unemployment in an economy already strained with government spending at 50% of GDP is politically difficult for any government, but it is the only way to receive continued EU support.
- 2) *Default in the near future (whilst staying in the euro)* and risk sinking into a severe downturn. Depending on the new terms of the debt, haircuts/reduced coupons/maturity lengthening could reduce the debt burden substantially. Nevertheless, without market refinancing and bailout funding, Greece would still find it hard to rebuild its economy.
- 3) *Leave the European Union and/or the euro.* Technically Greece could choose to leave the euro (they cannot be forced out), create its own currency and devalue its debt. It would reduce the debt burden and make labour and exports cheaper. But debt markets would be closed for Greece for a long time. Furthermore, any savings left in Greece would be devalued overnight, pensioners' buying power cut, and inflation likely to become an issue. Precedents from other country defaults, such as Argentina, are causing severe anxiety within Greek banks.

Fiscal consolidation seems to be the most feasible option if Greece is to continue receiving EU/IMF aid, and convince the market about its commitment to structurally fixing its problems. However, the austerity measures will result in many years of sub-par growth and great economic pain. Greece could choose to leave the euro or default to reduce its debt burden, but the loss of EU support and high economic and legal costs make this a low probability event at this point. For now, all hopes are pinned on the successful implementation of the austerity measures supporting the market's willingness to lend at a 'bearable' rate, and the bailout programs from Europe and the IMF.

The large European stabilisation package may have prevented another liquidity crisis, and reduced the risk of contagion, but solvency issues and unsustainable public finances remain a problem in Europe and elsewhere in the developed world. The following charts put Greece, and some other countries' fiscal positions, in a global context.



Source: OECD, Eurostat, Australian Treasury

Many of the problems that led to the GFC have not yet been solved. World imbalances are still large, and the debt overhangs are enormous in developed economies. The unprecedented emergency measures put in place during the GFC have helped to keep the financial system together, but only for the short term. The transfer of debt and risk from the private to the public sector should have been intended only to 'buy time'. In due course, public debt levels have to be brought under control and the overall leverage of the world economy reduced, even at the expense of lower growth for the next few years. Recent market developments reinforce that message very strongly.

For further information

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