The Greek Rescue

Last week, the European Union and the IMF jointly agreed with Greece on a € 110 bn rescue package, extending over 3 years, to finance Greece's fiscal deficits. To recapitulate the sequence, the Greek budget seemed in reasonable balance up to 2007. The global recession following the sub-prime crisis triggered a fiscal stimulus in Greece – as in many other countries as well. The difference was that Greece's sovereign debt levels were already high and there were attempts to "window dress" the true deficit and outstanding debt. A new government, which came into power last year, found, and disclosed, the true deficit to be as much as 13.6% of GDP! The bond yields started moving up sharply as bond ratings were downgraded.

The result was that Greece found it increasingly difficult to sell its bonds in the market except at a very high cost: and, fresh issues were/are needed to finance the continuing deficits and refinance maturing debt. Greece thus got caught in a vicious circle.

- ⇒ Large deficits and hence borrowing requirements;
- ⇒ Rating downgrades and higher yields in the market; and
- ⇒ The higher cost of borrowing further worsening the deficit making it even more difficult to reduce it to the eurozone's mandatory 3% level.

Many countries facing such a problem of unserviceable debt in the domestic currency have solved it by printing notes and generating inflation which in effect "devalues" the existing debt and brings down the debt to nominal GDP ratio. But Greece is in a peculiar position – the euro is its domestic currency but its supply is controlled by a supranational central bank over which Greece has no control. And, this has also created another problem – a huge deficit on the current account, a point we will come back to.

Meantime, the € 110 bn package is at lower than market rates but does not fully take care of Greece's borrowing requirements for the next three years, estimated at € 150 bn. The hope is that Greece will be able to bridge the gap through market borrowings after 2011. The eurozone members will finance roughly 2/3rd of the package, and IMF the balance. Even at the subsidised interest rates, it is expected that Greek sovereign debt as a percentage of GDP will keep growing to almost 150% by 2013, before narrowing slightly in the next year, when the fiscal deficit is projected to come below 3%.

As is to be expected, the bailout package comes with tough conditions on increasing taxes and reducing expenditure. Public sector salaries are to be cut. And the unions are up in arms against the terms of the rescue package. (Interestingly, Korean officials have criticized the terms of the rescue package as being too soft as compared to the IMF's conditionality in the Asian crisis of 1997-98. Surely, Europe's voting power in the IMF must have weighed.) Riots are taking place on the streets of Athens, and a few have died in police firing. Financial markets have not been very impressed; the euro and equity prices fell further after announcement of the package, and worries about the contagion spreading to other fiscally vulnerable eurozone members.

One major problem is growth: GDP is expected to continue to fall for the next couple of years and the deflationary fiscal medicine will hardly help! In a recent column in the Times of India (May 2), Swaminathan Aiyar argued that India should oppose the IMF loan to Greece because "the IMF was created to deal only with balance of payments problems" while this is a fiscal crisis. In many ways, however, it is a balance of payments problem given that Greece has a deficit of 14% of GDP on its current account, obviously not a sustainable level, and is hugely dependant on capital inflows to balance books. Even though the eurozone countries have the same currency, the fact is that over the years there has been a huge diversion in the "real" i.e. cost (inflation) adjusted, value of the currency: while the unit labour costs in Germany have fallen 15% since the birth of the euro, those in Ireland, Spain and Greece have gone up, thus widening the competitiveness gap sharply. The result is that Germany and other countries of the north are recording large surpluses on the current account even as the south goes deeper in deficits and unemployment.

In some ways the north south equation in Europe is not too different than the U.S. China relationship. Thanks to an undervalued currency, China records large surpluses and lends the surplus dollars to the United States by buying its treasury bonds. And, with a rock steady exchange rate the China U.S. imbalance is little different from the north south imbalance in the eurozone. The big question is whether the burden of adjustment in such cases should fall only on the deficit countries, or do the surplus countries also have a responsibility? Meantime one point is indisputable: the last 20 years experience evidences that, in an increasingly globalised economy, the biggest single threat to financial stability is an overvalued exchange rate.

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