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Greece Financial Stumbling: Impact on the Global Economy

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Abstract

This paper discusses the Eurozone crisis which took place in the year 2009-13 and the subsequent Greece's alleged default on its debt obligations in June 2015 which made the fastest growing economies lethargic. With the possible exit of Greece from Eurozone, adverse consequences for member countries might be manifold. So, we have tried to incorporate the impact of Greece debt crisis on different developing economies of the world. In the end, the paper attempts to suggest the steps to revive the world economic system and the possible solutions for Greece.

Keywords

Sovereign debt, Fiscal consolidation, Bailout package

Introduction

Economic crisis tends to occur periodically almost every decade in different country with different velocity and has different effects on the global economy. It has been observed that most economic crisis have been caused by factors such as overshooting of markets, excessive leveraging of debt, credit booms, miscalculation of risk, rapid outflows of capital from a country and unsustainable macroeconomic policies. The mortgage crisis of USA in 2007 turned out to be a serious debt crisis especially in Europe. The debt problem and its effects brought doubts about the future of European Union and Euro. Things were different in individual Eurozone countries, for example in Greece, a country with a weak political system, government debt rose at a much higher rate than the rest of the Eurozone and that in addition has a debt level exceeding 100% of GDP. So, while the Eurozone as a whole is no closer to a debt crisis than is the US, some of its member states have been moving closer to such a crisis. There are apprehensions that the fallout of member countries will have contagious effect on other member nations of Eurozone. The aim of this paper is to understand the causes of Eurozone crisis and worsening debt repaying capacity of Greece, possible effects of Greece's default and exit from Eurozone and policies that need to be undertaken to mitigate the adverse effects and to revive the

world economic system. In this context, firstly, the reasons of crisis in Eurozone in general and Greece in particular will be handled, and then the way ahead or possible steps for revival of global business and economic sentiment will be examined.

Eurozone Crisis

Hardly had the world economic conditions improved and revived from the sub-prime crisis, another crisis popped in the form of Eurozone crisis that originated in Europe and also extended to some parts of the United States. Eurozone is an assembly of 19 European countries who have adopted Euro as their common currency. The crisis emerged due to the inability of some member countries such as Greece, Spain, Italy and Portugal to pay off debts borrowed because of their deteriorating financial conditions.

During 2010-12 it became evident that four Eurozone states (Greece, Ireland, Portugal and Cyprus), facing persistent negative growth prospects and increasing government debt, would find it difficult or impossible to repay their government debt without the assistance of bailout support from international financial institutions. The Troika, a tripartite committee formed by the European Commission, the European Central Bank and the International Monetary Fund (EC, ECB and IMF) came in at that time with their assistance. The transfer of bailout funds was performed in tranches over several years and these funds were conditional on the governments' acceptance and simultaneous implementation of certain austerity measures including a package of fiscal consolidation, structural reforms & privatization of public assets and setting up funds for further bank recapitalization and resolution. Major causes of Eurozone crisis were:

- **Violation of European Union Rules**

  When the European Union (EU) was formed, countries like Greece and Cyprus did not presented the real financial and economic condition of their country. This fact was being ignored by EU as it did not scrutinized properly and accepted the countries with high budget deficit and debt levels.

- **Problem of Banking Sector**

The banking sector in Europe is much more susceptible and has shown a spectacular fall down since it got trapped in the global financial chain in 2007 financial crisis. The European banks were in a bad state as they were using their money to finance the government deficits and were unable to provide loans and advances to the general public and business class.

- **Rating Agencies**

These are generally considered as the most nervous actors in the financial markets. Credit rating is based upon the assessment of a country's ability to repay its debts. The role of rating agencies was crucial in terms of giving low credit rating and thus paving the way for crisis thereby causing the rise in the yields of the bonds and creating tension in bond market. This also made it difficult for the government to raise money in the market due to low trust among the creditors.

- **Political Conflicts**

It is well-known that politics and economics are the two sides of the same coin. The political system and its various policies influence the business environment. For instance, Germany relied to its austerity-led strategy to deal with the crisis.

According to Peter Praet, a member of the Executive Board, European Central Bank, there are other causes of the crisis which were as follows:

- The "US mortgage crisis is only the tip of the iceberg".
- Collapse of Lehman brothers in the year 2008, brought a transitory freeze in trade financing and also affected the global trade due to demand and supply shocks.
- The structure of the Eurozone as a currency union (i.e., one currency) without being a fiscal union (i.e., different tax and public pension rules) worsened the crisis thereby harming the ability of European leaders to respond.

In the Aftermath of Crisis

The global economy suffered a lot during the period from 2010-12. The average annual growth rate of global economy reduced by 0.65% and global unemployment rate increased by 1.81%. The trade in global market depressed with the fall in the average yearly growth by 1.14%. United States and China were the most affected countries in the world. In China, the growth rate reduced by 0.37 percentage points. This is because in the global economy economic catastrophes on the other side of the world can have real impacts at home. The demand of the goods in China continues to be in depression, and there is a fall in the investment and the consumption of the other countries which is caused by the European Sovereign debt. Thus, the European debt crisis and recession affected exports and the stock market in the economies of its trade partners.

Greece's Debt Crisis

It all began in 2009 when the credit rating of Greece slashed from A- to BBB+, the lowest credit rating in Europe. This was due to the possible disclosure that Greece government has been understating its public debts for years. Greece government has always been generous in its public spending and after entering the Eurozone in 2001, the avenues of borrowing rose further and Greece’s spending on infrastructure, services and other public programs increased. Most of the debt that Greece holds is from within the Eurozone especially from the countries like Germany and France and a very small part of debt is owed outside the Eurozone. Years of unrestrained spending, cheap lending and failure to implement financial reforms left Greece badly exposed when the global economic crisis stuck. Its deficit reached to unbearable levels of almost 12.7 % (more than four times the maximum allowed by EU rules) which had to be met from loans from outside the economy.

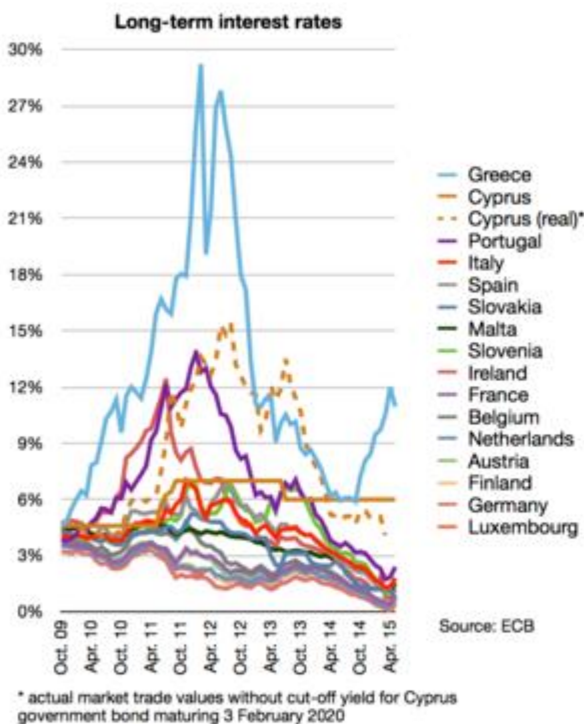
In this period, Greece was exposed to continuous credit-rating downgrades by international rating agencies, and rapidly increasing borrowing costs made the public debt management unsustainable. In January 2010, first bailout package called the help in the form of loans was granted but it was too small to meet Greece’s spending targets which were expected to reach 160% of GDP by the end of 2011.

The Troika, a tripartite committee formed by the European Commission, the European Central Bank and the International Monetary Fund (EC, ECB and IMF), offered Greece a second bailout loan

worth €130 billion in October 2011 (Second Economic Adjustment Programme), but in return of certain tough conditions regarding the implementation of austerity measures and the debt restructuring agreement. Austerity measures are attempts to significantly curtail government spending in an effort to control public-sector debt, these may include curtailing pensions for government workers, welfare and government-sponsored healthcare, programs that disproportionately affect low-income earners at a time when they're financially vulnerable.

As a result of downward revision of government spending and higher taxes, recessionary conditions started building up in the economy. The share of population living at "risk of poverty or social exclusion" which remained almost stable at 27.6 % in 2009 and 2010 rose sharply above 33 % in 2011. In February 2012, an IMF official negotiating Greek austerity measures admitted that excessive spending cuts were harming Greece.

At the same time, lenders started demanding higher rates of interest, these were four times higher than the nominal rate of interest. There were other countries too like Portugal, Cyprus and Ireland which were also in trouble that time. The credit ratings of troubled countries were continually downgrading, while the other countries were imposed to threats.



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In 2013 and 2014, Greece started reviving as can be seen in the figure from the slashing interest rates. The Greek economy achieved a government structural surplus both in 2013 and 2014, along with a decline of the unemployment rate and return of positive economic growth in 2014. As a result of this improved outlook, Greek government regained access to the private lending market for the first time since eruption of its debt crisis - to the extent that its entire financing gap for 2014 was filled through the sale of bonds to private creditors.

The improved economic conditions were further dismantled in the fourth quarter of 2014, as a result of coming to power of the radical left party Syriza in Greece which fiercely refused to respect the terms related to bailout agreement. This resulted in suspension of all scheduled aids to Greece from Troika, which caused liquidity crisis for Greek government and financial system and crashing of stock markets in Greece. The situation further deteriorated when private lending interest rates hiked and there were no other sources of funding accessible to Greeks. On 30 June 2015, by missing the deadline to repay IMF's debt amounting to about 1.5 billion euros, Greece became the first developed country to default on its debt payments. The term default is generally not used rather it is said that the country fell into arrears on payments to the fund. Greek government resorted to referendums to seek the view of its public on the acceptance of bailout funds on the basis of stringent austerity measures and their willingness to remain in Eurozone. So, the consequences of a 'Yes' or 'No' needs to be seen. In any scenario this is going to be a crucial period for Greeks and the other members of Eurozone, as Greek banks are totally out of funds and more debt repaying obligations are on its way in the upcoming months.

In short, the reasons for Greece debt crisis are:

1. High public sector wage and pension commitments.
2. Unsustainable budget deficits and debt levels.
3. Political instability.
4. Continued referendums in the economy for taking government borrowing decisions.

Adverse Effects of Greece's Possible Default or Exit from Eurozone

1. According to Japanese financial company, Nomura, an exit would lead to a 60% devaluation of the new drachma (Greece's currency).
2. Analysts at French bank BNP Paribas inferred that the Greek exit would wipe 20% off Greece's GDP, increase Greece's debt-to-GDP ratio to over 200% and raise inflation to as high as 40-50%.
3. Also, UBS warned of hyperinflation, a bank run and even "military coups and possible civil war that could afflict a departing country". Eurozone National Central Banks (NCBs) may lose up to €100bn in debt claims against the Greek national bank through the ECB's TARGET2 system. The Deutsche Bundesbank alone may have to write off €27billions.
4. A default by Greece may cause investors to lose faith in other Eurozone countries and this may have cascading effects on other economies.
5. Greece's problems have already starting spilling beyond Europe's borders. The value of euro currency has plunged which has made US exports (a key source to US economic recovery) less competitive.
6. The developing countries like India who depend heavily on FDI and FII would face liquidity crisis because of capital flight.
7. All the stock markets would suffer heavily and the markets of the developing countries like India may crash. However, the authorities in India have assured Indian economy to be insulated from Greek crisis but in such a globalised world, no economy can remain untouched by the crisis in other parts of the globe.

What developing countries can do to lessen the adverse effects?

It is generally assumed that to generate a self-sustaining global economic recovery, big countries in East Asia, especially China, whose trade was adversely affected during the Eurozone crisis in 2011-2013 must initiate a policy change. These nations must shift away from dependency on imports from developed countries towards domestic demand. There are several steps that developing countries can

take in bringing down the impact of Eurozone crisis, to revive world economic system and for their own sustainable growth.

- Reducing the current account deficit(CAD)
- Reducing import of oil and gold
- Exports need to be enhanced as they are the main drivers for the recovery of the economy.
- Globalisation of finance
- Establishing closer ties by enhancing regional and other multilateral trade agreements.

Possible Solutions to Greece Crisis

- **Default or restructuring**

Looking at the present level of debt owed and its financial position, default or restructuring are the most probable solutions for Greece. An outright default is a rare possibility, however debt restructuring is possible provided the bailout funds are available. The main costs associated with debt restructuring are the time and effort negotiating with bankers, creditors, vendors, and tax authorities. Reduction and renegotiation of debt under debt restructuring would result in only part payments of huge debts owed to IMF and Eurozone countries which may destabilize Euro Interbank Offered Rate. This rate backs the government securities and will be influenced by the credit position of governments of Eurozone countries.

- **Withdrawal from the Eurozone**

The level of debt outstanding in Greece is so high that the economists world over have started predicting that a default for Greece is sure, sooner or later. The default at a later point of time would affect Greece and other Eurozone members even more. If Greece remains within the Eurozone on the basis of acceptance of fiscal austerity by the lenders, then it will result into higher bond yields and higher interest rates which might dampen demand, raise savings and slow down the economy.

Fiscal austerity will call for containing large deficits through contraction in government spending which will improve its trade through lesser imports and less reliance on foreign capital.

In the other scenario of Greece's not being the member of Eurozone, through its exit, the rest of the Eurozone can be relieved. But this solution also comes with several shortcomings or ill effects in terms of:

1. Major capital flight from Greece, which might be compensated by printing domestic currency, which may in turn lead to inflationary pressure in the country. Savings will be destroyed and discouraged.

2. Greece's currency will devalue thereby making imports more expensive.

3. This may promote other marginal economies to leave the Eurozone.

4. Unprecedented exit of major Eurozone countries like Spain and Italy (experiencing similar debt crisis), which may affect the very existence of Eurozone.

- **Bailout by other Eurozone countries**

In the present global scenario, all economies are driven by self-interest. Bailing out Greece in this hour of crisis is in the own interest of Eurozone members. This is because:

1. A significant part of Greece's debt is owed to the financial institutions of Eurozone countries. In the event of Greece's default and in turn bankruptcy of these institutions, governments in the Eurozone countries will have to come to the rescue of these institutions. So, directly or indirectly the member countries are to play their role as 'lender of last resort'.
2. In order to prevent the contagious effects of Greece's failure in the bond markets of Eurozone, they must rescue Greece in the form of bailout funds. Greece's fallout would spread panic in the economies of other Eurozone members (having similar budgetary problems) thereby

making their financial markets vulnerable. Pessimistic investors might return Government bonds in the desire to hold liquidity.

3. In fact the voluntarily bailing out some member country is truly within the confines of legal framework of Eurozone. The costs associated with bailing out Greece would be much lower than the costs that member countries will have to bear in case Greece defaults and lead to financial crisis.

- **A helping hand from China**

China being a large trading partner of EU has a considerable interest in preventing a fallout in Eurozone. China's comfortable fiscal capacity in terms of a tremendous foreign reserve of $3.2 trillion would be sufficient to bailout Greece. Its foreign reserve can help Greece to pay its debt obligation and can get long term returns at high interest. If the euro depreciates then it would affect the profit margins of China. China has already experienced the adverse consequences of Euro crisis of 2011-13 which it would surely doesn't want to experience again.

- **A third bailout from Troika**

In line with the earlier two bailout packages offered by Troika to Greece, a third bailout may work for containing the deficits and meeting the expenditures of crisis-ridden government. This solution is highly contingent upon the attitude of Greek government on the terms of austerity related measures. This is because the conditions of fiscal consolidation and expenditure controls will be highly stringent this time around.

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