

Greece, the euro and British business

Eurozone traders should prepare for the fallout



We're not looking for scapegoats. These are problems of our own making.

George Papandreou
Prime Minister, Greece

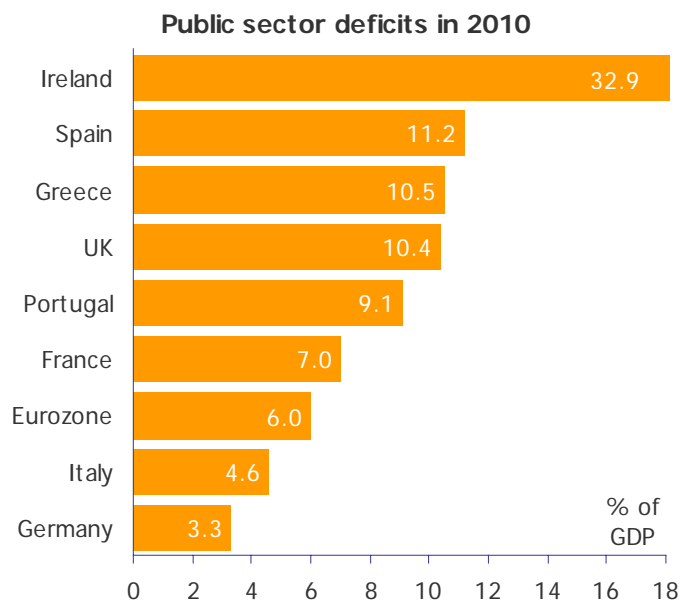
Events in Greece may seem far off to British businesses, even those with extensive eurozone interests. But the potential outcomes of the Greek crisis will have profound effects on the UK's trading relationship with the eurozone, the monetary management of the eurozone and sterling's euro exchange rate.

Successive Greek governments have run budget deficits that have become unsustainable. Even worse, evidence emerged in 2009 that the extent of the deficits had been covered up. Greece needs to borrow from the bond markets to repay existing debts. Understandably, confidence among investors that Greece will honour its debts has been undermined.

International rescue

If Greece were to default on its debt by refusing to honour its maturing bonds, the euro's value and, indeed, confidence in the eurozone project, would be damaged. So in May 2010 a trio of creditors—the IMF, the European Commission and the European Central Bank— put up a €110bn loan for Greece to dip into should it need to.

The intention has been to persuade investors that there should be no problems for Greece in repaying its debt.



Maturing Greek bonds would be honoured at their face value.

But the loan came with strings. The lending 'troika' insisted on structural reforms of the economy: smaller government, reduction in the budget deficit and de-regulation of Greek industry to lift productivity.

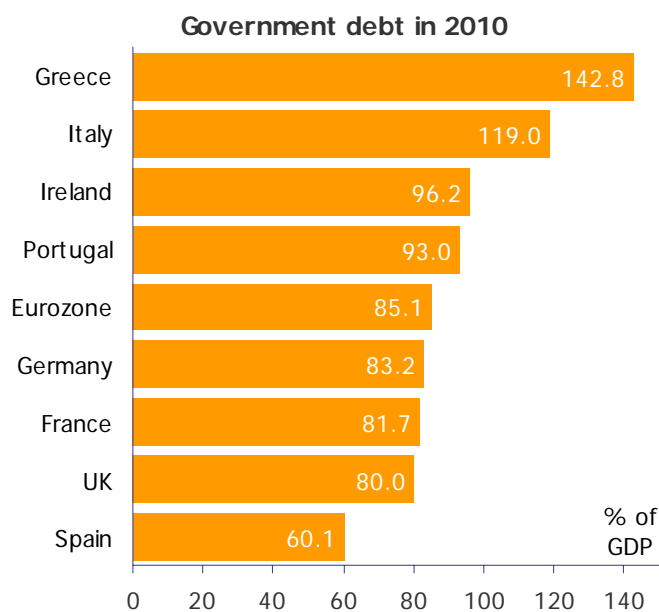
A year on and the lenders are expressing their frustration at a perceived lack of progress. They see the Papandreu-led government as slow to grasp a once-in-a-lifetime opportunity to pass much-needed fundamental reforms with its large majority.

After some early success with state pensions and salaries, the momentum for reform seems to have withered. This has perhaps been in response to the regular violent street protests in Athens and the contraction of the economy. Greece's GDP was 4.8% down in the first quarter of 2011 compared to the same quarter in 2010.

In April 2010 Athens outlined its latest initiative. A €50 billion privatisation programme would cut state sector debt by 18 per cent of GDP by 2020. European policy makers remain sceptical, though, about the practicalities of the programme and with concerns over policy drift.

Progress so far

Greece successfully reduced its fiscal deficit from 15.4% of GDP in 2009 to 10.5% in 2010, mostly through deep public spending cuts. But as the IMF acknowledges, there is further progress to be made in raising revenues from income taxes, corporation taxes, fuel and excise levies and VAT.



Moreover, long-needed centralisation of the public payroll has been effected and the number of municipalities has been reduced. But the real structural reform ahead lies in further reduction of state pension liabilities and breaking up the closed-shop professions and trades.

(Debt restructuring) would raise incredible doubts about our credibility if we simply were to change the rules in the middle of the first programme.

Angela Merkel
Chancellor, Germany

The pain won't go away soon

The EC expects the Greek economy to contract a further 3.5% this year. If so, this would be the third consecutive year of decline. The economy's output would be 9.7% smaller than it was in 2008.

Even so, there are signs that acceptance of the need for change seems to be spreading from the business and political communities to a broader base.

But Greek sovereign debt has been downgraded by the credit rating agencies. Yields on Greek ten-year bonds (a measure of the bond market's evaluation of default risk) have risen to record levels of close to 16%.

Even more telling is the spread on German bond yields (the difference between Greek and German government borrowing costs) which exceeds 12%. Yields on three-year bonds, which the Greek government must rely on to roll debt over, exceed 24%. Investors want to be rewarded for the risk of holding Greek debt. Some leading global fund managers have even warned that they will not hold Greek bonds.

Broader tensions

This has been the eurozone's first genuine financial crisis and it already seems that the euro may be damaged for some time.

Moreover, the tortuous deliberations in arranging the Greek rescue package revealed fundamental differences in attitude and approach to prospective debt default among the leading eurozone economies.

The loan has provoked unrest in northern Europe and is reviving stereotypes of profligate southern European states requiring subsidy, a prospect particularly resented by German and Finnish citizens.

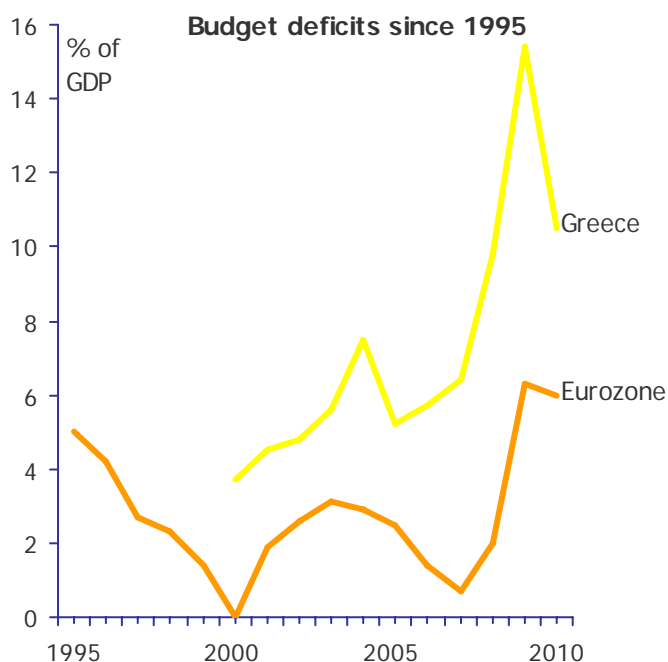
For their part, some Greek nationals with long memories express revulsion at the idea of a Germany-led rescue plan. And involvement of the IMF is telling the world that the eurozone cannot yet manage its own currency area.

Greece's euro deal

Greece adopted the euro in 2001, two years after the founding members. When Greece surrendered the drachma, it signed up to an implicit contract with the rest of the eurozone.

After decades of high interest rates (borne of high inflation and government debt), Greece would gain from much lower eurozone interest rates. These lower borrowing costs would facilitate faster economic growth, more job creation and lower debt service costs. In return, Greece would surrender devaluation as a policy tool. Greece subscribed to the northern European disciplinary model of low inflation, government debt and interest rates.

In previous economic cycles, Greece had emerged from bouts of high inflation and fiscal and current account deficits through devaluation. The drachma would lose value to the deutschemark, franc, lira (etc) restoring the price competitiveness of Greek exports while making imports more expensive. Employment levels would increase along with tax revenues, while state spending liabilities would decline, closing the fiscal and trade deficits.



But not this time. The previous Greek administration, which lost power in June 2009, had misled the world on the extent of its deficit spending for years.

Some of this debt is in short term loans, due for repayment over the next two years. The Greek government must take out new loans to repay the old ones (debt 'rollover'). The imminent danger is that it might not be

For starters, we will not default. Secondly, this is not a bailout. It's not free money. The problem is the cost of borrowing and how long we can sustain that.

George Papandreou,
Prime Minister, Greece

able to raise new loans and so will be unable to repaying the existing loans. The EC/IMF loan facility is there to persuade the bond markets that this will not happen.

Ironically, having secured the EC/IMF loan, the Greek government will try to not to use it. By drawing on the EC/IMF funds, it will be conceding to the bond markets that it is insolvent. This admission alone would reduce bond prices and push up yields, increasing borrowing costs. And the EC/IMF loan would be 'senior' to private sector claims.

This means that in the case of default, repayment of the rescue package would take priority to holders of Greek bonds. Again, this would add to the risk premium of holding Greek bonds, reducing their prices and increasing yields.

Unwrapping the package

After several weeks of nervous negotiation in May 2010 the eurozone nations put together a €30 billion loan facility. Curiously, this included donations from members who also faced daunting fiscal deficits. The psychological boost immediately lifted the euro's value and reduced Greek borrowing costs, although both these movements reversed shortly after.

The IMF is holding Greece to some testing loan conditions, sparing Germany from playing the enforcer. These conditions include fiscal targets, more openness in public finance data and structural reforms to restrain wages and reduce pension rights. Greece must run a primary budget

surpluses (excluding debt interest payments) of up to 6% of GDP.

The interest rate of the EC component of the loan was also the subject of extensive negotiation among the lenders. Germany had insisted on market rates, which might have encouraged Greece to go it alone. The agreed rate is 3.5 percentage points above the 'risk-free' rates for euro loans, currently about 1.6%. While still demanding, this rate is lower than the bond markets were asking. The IMF part of the loan is likely to be less costly.

The real story

There are two realities that the rescue package cannot help. The first reality, competitiveness, is the real story here. Since 2001, Greece has lost competitiveness in European export markets, notably to Germany and Spain. Greek labour costs have increased more quickly than German labour costs, among others.

The result has been that Greek export sales have lost market share. Greek jobs have been lost and income growth has slowed along with the tax yield. Meanwhile the state's social security liabilities have increased with rising unemployment and pension obligations. The state's fiscal deficit has ballooned.

The second reality underlying this story is that the Greek public finances are unsustainable. The EC/IMF bailout has delayed default but has not eliminated its possibility. Greece's national debt will (conservatively) need over €40 billion to roll over existing debt and cover interest payments. This is about 16% (or two month's) of gross domestic product. The economy is likely to contract this year, so these payments will have to be made while tax revenues are falling.

To survive without further bail outs, the Greek government needs to turn its primary budget deficit of over 7% of GDP into substantial primary surpluses. The Greek government's late efforts to reduce tax evasion are unlikely to be sufficient to prevent a reduction in tax revenues. To secure a fiscal surplus, the government needs to continue to cut expenditure.

Even if this fiscal surplus is achievable, the economy also needs to regain its lost competitiveness. This can only be achieved through structural reforms which reduce wage rates and sustain productivity improvement. But wage reductions would demoralise the workforce and could lead to price deflation. Income tax and sales tax revenues for the government would fall, jeopardising the fiscal surpluses. The Greek economy cannot continue to operate in the way it has done.

Inevitable default

Monetary union across Europe was initially perceived as a likely consequence of political union. But when, in the early 1990s, it became clear to the EU bureaucrats that political union would only be achieved over decades (if ever), the option of promoting political union through monetary union began to appeal.

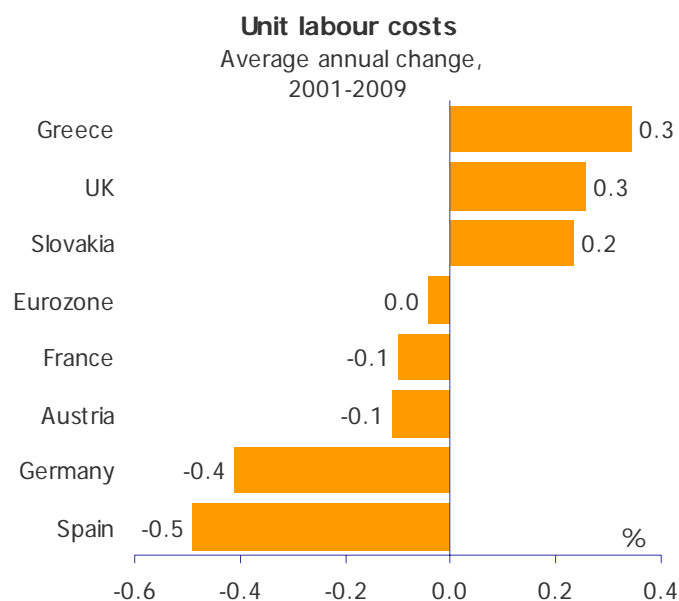
Few have ever doubted that a single currency area without co-ordinated fiscal policy would always be vulnerable to the conflicting needs of individual member states and the currency area as a whole. Lack of fiscal policy co-ordination will remain the euro's potentially fatal flaw.

In some ways it is surprising that this crisis has not materialised sooner. The Maastricht rules on public debt (annual deficits no more than 3% of GDP, overall debt less than 60% of GDP) were very quickly dropped when the extent of the credit crunch became apparent in 2008. In any case, the latter rule was never taken seriously by the European Central Bank. The eurozone's collective national debt has never been below 65% since the euro's introduction.

[70% of Greek government debt is held outside of Greece. It will be foreign bondholders who would bear most of the capital losses.]

The yields currently demanded by investors to hold Greek bonds are unsustainably high. Buyers of Greek debt are already building in some default loss. After a meeting of finance ministers in early May, the EU has signalled that it will try a 'soft' restructuring first. This would involve lengthening the maturities on bonds and/or reducing their interest rates.

Such a move could buy some time, but 'hard' restructuring appears to be the most likely outcome. 'Hard' restructuring of debt would mean significant write-downs of debt of at



least 30%, possibly as much as 60%. And humiliating as this outcome would be for Greece, it would not necessarily preserve its euro membership.

Out could still be better than in

Write-downs would reduce outstanding debt but would not cut the Greek budget deficit (the difference between current spending and revenues) by very much. This is because debt interest is only a small part of the budget deficit. Investors would be no more moved to hold Greek debt than they are now. Greece's economic growth prospects would be just as bleak (with years of public spending cuts ahead) and a second bail-out would be unthinkable.

This would leave just two choices for Greece. Some sort of fiscal transfers could be arranged. This would effectively mean northern Europeans paying the taxes of Greek citizens. But public opinion in northern Europe is moving away from this possibility. The other option is for Greece to leave the eurozone.

There would have to be a negotiated withdrawal, with debt redenominated in a revived (and devalued) drachma, reducing the euro value of Greek bonds. The Greek banking system would have to be carried, and temporary capital controls would be needed to prevent panic flight.

The business implications

The euro has suffered increased volatility in its dollar and sterling exchange rates as the Greek crisis has unfolded, despite Greece accounting for less than 3% of eurozone GDP. It seems that the currency markets have been disturbed by the issues of fiscal responsibility within the eurozone and the lack of action (so far) by the ECB to control country deficits.

If this volatility continues, it will add to the uncertainty in pricing for British companies exporting to and importing from the eurozone. It will also increase the cost of currency futures and options contracts that British companies may use to minimise this currency risk.

With similar stories to come from Ireland, Portugal and possibly Spain, it seems that the primacy of the euro is not to be taken for granted. As the governments of these countries implement the public sector spending cut backs and real wage reductions necessary to curb their deficits, local euro-scepticism is bound to foment.

It will be something of an accomplishment for the ECB and the EU parliament if the eurozone remains in tact over the next two years. British companies with extensive trade links with the eurozone may consider preparing themselves for the potential exit from the eurozone of one or more members in the next few years.

The recent advancement in euro-scepticism across northern Europe is likely to spread to the UK and rule out the chances of a leading political party advocating euro-adoption, for at least a decade and probably much longer.

Moreover, several EU members in Eastern Europe had aspired to join the eurozone in the next few years. Events in Greece may emphasise to their electorates the advantages of retaining their own currencies. Any reversals in their eurozone aspirations should influence the investment plans of British companies looking to expand operations in these countries.

One positive outcome for British industry of the Greek crisis is its effect on sovereign debt. The lack of enthusiasm in the bond markets for holding Greek debt (among other sovereign states) suggests that conditions in the corporate bond markets might become more favourable over the next two years.

With fewer doubts of the corporate sector's ability to repay, corporate bond prices are likely to increase (reducing yields and borrowing costs) as fund managers swap sovereigns for corporates. This will make it easier and cheaper for companies to borrow in large quantities. ©

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