

Focus: Greece Debt Crisis

Just a few months back as the key global economic indicators ascended on the recovery road, there was cheer all across the globe. While all seemed to be going well for the global economy, it was the surfacing of concerns over fiscal situation & competitiveness of Greece, which enlarged in to a general concern about the fiscal sustainability of advanced economies, stability of European Union & financial stability of the global economy, that has once again cast doubts over the recovery of the global economy and sparked fears of a 'Double Dip Recession'.

In Greece, at the end of 2009, the fiscal deficit reached 13.6 percent of GDP and public debt had increased to 115 percent of GDP. This was in stark violation of *Maastricht* rules of the European Union (EU) that allow max budget deficit of 3% and debt of 60% for each member country. Till recently, creative accounting & currency derivatives were being used extensively to mask the true level of government deficit & debt position.

What is at the root of the crisis?

High Government Expenditure

Traditionally, Greece has had a large public sector and a very generous social security system. This, of late has been coupled with low retirement age, high pension rates and rising proportion of aging population. Further, increases in wages in the past few years were not in sync with increases with productivity, with the latter lagging. In fact, in 2009 wages (public sector) & social security benefits, together accounted for 75% of the total government expenditure (excl interest payments).

High level of Government Borrowings

Greece became a member of EU in early 2000s and since then has been on borrowing spree. Being a part of the EU, made borrowing easy for Greece because of lower exchange rate risk

associated with Euro, and along with this European banks were in search of opportunities to lend.

Deteriorating Current Account

Greece's current account deficit rose from 6% of GDP in 2004 to 14.3% in 2007. Rising wage inflation resulted in loss of competitiveness (relative price of a representative basket of goods in Greece vis-à-vis other countries) of Greece. Since adoption of the Euro, Greece's competitiveness had declined by 25 percent, hindering growth and necessitating imports to be financed through external debt.

What intensified the problem?

The fiscal situation in Greece became more precarious with the onset of global recession, economic activity slowed and unemployment rose, which meant lower tax revenue & higher out go on social security benefits. Besides, the government had to increase its expenditures further as a part of economic stimulus package. In addition, financing costs for Greece also rose rapidly with rise in interest rates, adding to the already high debt burden. At this stage the unsustainable nature of government spending & financing system in Greece became evident and the threat of sovereign default became real.

How it is being addressed?

First, EU governments along with the International Monetary Fund(IMF) have offered a €110 billion rescue package to Greece, which has attached to it tough austerity conditions. The austerity drive aims to reduce fiscal deficit from 13.6% (2009) to 3% in 2012.

Second, EU governments along with the European Commercial Bank and the IMF have decided to directly buy into bonds threatened by default and assist Greece to prevent default.

The potential magnitude of problem

The precarious fiscal situation is not limited to Greece; other EU economies namely, Portugal, Ireland, Italy & Spain (all together called the PIIGS group) have high deficit & debt ratios. In event of default on debt obligations by any of these there is a fear of the contagion spreading to the other EU countries & their banks, from which these countries have borrowed heavily. Barclays Capital has estimated that French and German banks and insurance groups hold close to €80 billion in Greek sovereign debt.

Epilogue:

The global economic recession began with the problem of malignant debt in the private financial sector & banks. However, today while the initial problem is being addressed, the biggest financial concern for the global economy is sovereign debt. There are two aspects to this problem, while on one hand there are concerns that individual countries may default if they do not cut their deficits and that banks holding their debt will be clobbered. On the other hand there is a worry that if several governments try to tighten fiscal policy at once, the global economy will take a hit.

Week that was

- Annual wholesale price index inflation for the month of June 2010 was 10.55% up from 10.16% estimated for May 2010.
- International crude oil price (WTI) rose to US\$75.88 /bbl on 16th July 2010 from US\$71.68/bbl on 2nd July 2010 and Indian Crude Basket price rose to US\$74.08/bbl on 16th July 2010 from US\$ 71.04/bbl on 2nd July 2010.