

Greece's sovereign debt crisis and its impacts on the global economy

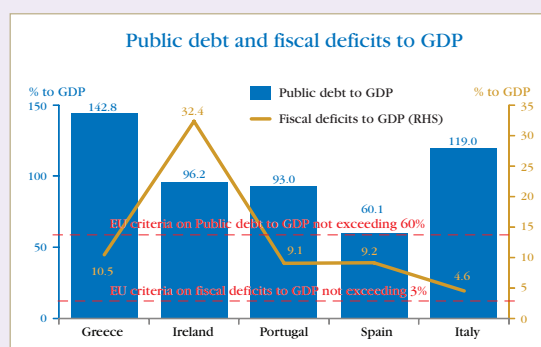
The sovereign debt crisis in Greece has been an issue in world financial markets since the end of 2009. In May 2010 Greece became the first euro-area country requesting a financial rescue from the European Union and International Monetary Fund (EU/IMF) worth €110 billion. Although it has been more than a year since the bailout, the public debt problem remained unresolved as attested by (1) the rise in Greece's two-year government bond yields of more than 300 basis points; (2) the continuous downgrade of Greek sovereign rating to below investment grade even under the EU/IMF program; and (3) the rise in Greece's credit default swaps (CDS) to a steep 23.5 percent (as of 14 July 2011), reflecting around 87 percent probability that Greece may default within the next five years. Most important, the Greece crisis has spread to other peripheral countries, namely Ireland and Portugal, which have also requested financial assistance from the EU and IMF in November 2010 and April 2011, respectively. This sovereign debt problem has become a significant risk to the world financial market and economic recovery.

Causes of the Greek debt crisis

Greece's public debt has been at an elevated level since 1989 and as of the end of 2010 amounted to €329 billion or 148.2 percent of GDP. Such a high public debt to GDP ratio is almost three times larger than the threshold set by the Maastricht Treaty that stipulates member countries' public debt not exceeding 60 percent of output. Greece has also experienced large fiscal deficit, which registered at 10.5 percent of GDP at the end of 2010 higher than the euro area average of 6.0 percent and one of the highest in the world.

The sovereign debt crisis in Greece is primarily caused by four factors.

The first is the lack of fiscal discipline due to populist welfare policies, e.g., three-times-a-year bonuses as well as a minimum retirement age of 50, which is below the international average, and the attendant entitlement for pension benefits that is inconsistent with the average lifespan. Such policies led to increases in public spending, particularly on wages, pensions, elderly aids, and unemployment benefits, which accounted for more than 75 percent of Greece's public expenditures.



Source: Eurostat

The second factor is the mismatch between government revenues and expenditures. Greece's public spending excluding interest payments accounted for 32 percent of GDP, while public revenues excluding social security contributions amounted to only 20 percent. This discrepancy is due partly to inefficient tax collection, as well as tax invasion particularly among high-income bracket individuals, resulting in ongoing fiscal deficits. Greece also needed to make substantial interest payments due to a large amount of borrowings from financial markets during the past ten years. Being a member of the European Union was also a factor that helped Greece to borrow cheaply. Greece's long-term interest rates and long-term government bond yields significantly declined after it became a member of the European Union.

Third, Greece's competitiveness is declining relative to its peers in the European Union. A measure of Greece's competitiveness has decreased by more than 25 percent since becoming an EU member in 2000. The average wage and unit labor cost in Greece were higher than the counterparts in the euro area. These were the main obstacle to economic growth that will also adversely affect tax revenues.

Finally, during the global financial crisis in 2008, the Greek government spent extensively to stimulate the economy, contributing to the large fiscal burden and loss of investor confidence in the government's debt repayment ability. Since the end of 2009 Greek sovereign bonds' ratings were continuously downgraded to below investment grade, driving up financing costs and reducing the likelihood of paying back their debts.

Solutions to the sovereign debt crisis

The EU/IMF solution to the Greek problem has been mainly focused on liquidity risks in the medium term. Between now and 2014, after which it would need to raise funds from the financial markets again, Greece is expected to restructure economy under the bailout conditionality by implementing fiscal austerity measures, including decreasing public expenditures and raising revenues to curtail fiscal deficit. Nonetheless, the credibility of the program has been questioned, particularly at the end of last year when Greece failed to achieve EU/IMF conditionality as the economy unexpectedly contracted by 4.5 percent owing to weak domestic demand. The financial package, initially expected to end in 2013, has thus been extended to end a year later. In addition, given two-year government bond yields rose significantly, Greece inevitably requested for the second bailout.

Being a euro area member precludes the possibility of currency devaluation as generally practiced by countries that receive aid from the IMF. As a result, Greece's foreign currency earnings, which came mainly from tourism and maritime transportation, did not increase much. Investors also questioned Greece's ability to repay debts given the delayed fiscal consolidation.

Recently, there is a proposal for involvement of the private sector in sharing some burden through a rollover of Greek bonds. Nonetheless, many analysts view such a move only to buy Greece more time and not constitute the solution. Furthermore, this proposal could be regarded as a technical default by credit ratings agencies and potentially trigger credit event.

Table 1 Commercial banks foreign claims as of December 2010

Billions USD	Creditors countries						Total
	Germany	France	United Kingdom	Netherland	US	Belgium	
Greece	34.0	56.7	14.1	5.0	7.3	1.9	119.0
Portugal	36.4	26.9	24.3	6.5	5.2	3.5	103.0
Ireland	118.2	29.6	135.2	16.7	50.9	25.4	376.1
Spain	181.9	140.6	107.2	76.9	47.2	21.5	575.3
Italy	36.4	26.9	66.4	45.3	36.7	25.8	729.1
PIIGS	532.7	646.5	347.2	150.5	147.5	78.2	1,902.6

Source: BIS

Potential impacts on global economy

Greece's sovereign debt crisis directly affects its citizens, especially through fiscal-tightening measures. Despite many ongoing efforts from various institutions to find an appropriate solution, if comprehensive and sustainable solutions could not be reached, the crisis could have large impacts in global financial markets and could ultimately affect the world economy through the following channels:

Investor confidence. Credit default swaps of PIIGS rose significantly during the past two months, resulting in higher financing costs of those peripheral countries.^{1/} Rising borrowing costs adversely affect ability to repay, potentially leading to default.

Financial markets. Exposures to Greek debts by commercial banks in France and Germany, in terms of ultimate foreign claims to public and private assets, total approximately \$57 billion and \$34 billion, which are equivalent to 1.8 and 1.2 percent of total foreign claims, respectively.^{2/} If Greece defaults, those commercial banks will unavoidably face capital losses. If the problem spreads to other PIIGS countries, it can lead to credit crunch. Moreover, the majority of Greek bonds are issued under Greek law, which can make claims by foreign investors difficult.

Table 2 Share of export
(By countries)

(% to total exports)	Exporting countries						
	EA-16	EU-27	US	Japan	China	Asia-7	World
Greece	0.9	0.9	0.1	0.2	0.3	0.3	0.6
Portugal	1.3	1.1	0.2	0.1	0.2	0.1	0.6
Spain	4.7	4.3	0.9	0.6	1.5	0.9	2.6
PIIGS	13.0	12.9	3.2	1.9	4.1	2.5	7.8
EA-16	57.9	51.4	16.0	10.8	15.6	9.0	29.3
EU-27	66.5	66.8	21.2	14.1	20.5	12.6	38.1

Note: Asia-7 consists of Taiwan, Thailand, South Korea, Indonesia, Philippines, Hong Kong and Singapore

Source: BOT staffs' calculation based on database from Trademap

Trade. If the problem is contained within PIIGS, the impact on the global economy is expected to be limited as exports to the periphery countries account for only 8 percent of world exports, although EU intra-regional trade would be more affected as exports to PIIGS account for 13 percent of total EU exports. If core countries become affected, impacts on the world economy would be severe because the European market accounts for one-third of world

exports. The sovereign debt crisis in Greece thus poses a significant risk to the global economy and world financial markets if there is no concrete solution.

With regard to Thailand, the impact on the Thai economy is judged to be limited, as financial claims by Thai investors, including financial institutions, on European economies are minimal. The impact through trade is also marginal as Thai exports to PIIGS accounts for 1.8 percent of total Thai exports. Nonetheless, the Thai economy will be indirectly affected from volatilities in foreign exchange and stock markets worldwide. As the crisis is unfolding, future impacts will largely depend on the severity and the degree of contagion of the problem.

^{1/} PIIGS comprises Portugal Ireland, Italy, Greece and Spain.

^{2/} Includes direct loans, investments in government bonds, and corporate bonds.