

# Greece's Gordian Knot

Outlook into 2010 and beyond

How will Greece untie the Gordian knot of unsustainable debt levels? Massive fiscal restraint and support from the rest of the eurozone seem the most likely answers. Alexander the Great's solution to the original problem, of course, was simply to cut through the knot with a sword. The modern day equivalent would be to leave the eurozone and start over. That's the kind of anti-European solution that some Anglo-Saxon analysts like to push, but for better or for worse the most likely outcome is one which causes significant pain to the Greek economy.

Greece's problem is that its level of national debt is now growing rapidly to the point where turning it around is going to be extremely difficult. Real GDP is likely to shrink by a little over 1% in 2009 and the economy is forecast to still be in recession in 2010, shrinking by 0.3% according to the EU Commission. That is not very heartening but by the standards of many economies, it's still a mild fall in output. It is somewhat alarming therefore that Greece's national debt/GDP ratio has increased from 95.6%, in 2007 (smaller than Italy's debt burden) to 113% GDP this year and is forecast to reach 135% in 2011.

## Ratings and the ECB

The catalyst for the current market crisis was the announcement by the ratings agency Fitch that it was downgrading Greece's credit rating from A- to BBB+. Standard and Poors followed, putting it's A- rating on CreditWatch negative. The result in financial markets has been to push up the cost of buying credit default protection on Greece from 100bp over five-year swap rates in August, to around 210bp today. Compare that to 560bp for Dubai, 78bp for the UK and 22bp for Germany.

The downgrade matters for a number of reasons. At one level, it reduces international appetite for Greek debt and raises its cost. But it is also important because of what it could potentially mean for Greek banks' access to ECB liquidity. Until October 2008, the ECB allowed banks to post collateral with it in return for access to liquidity through its repurchase facility, as long as one of the three main rating agencies gave the issuer of the collateral an A- rating. In practise, that meant that any eurozone economy's banks could post their own country's national debt in exchange for getting access to liquidity from the ECB. In October 2008, as part of the measures aimed at increasing the liquidity available to

the system, the ECB extended its criteria from A- to BBB+ and in May 2009 they announced that these new, more relaxed criteria would be kept in place until the end of 2010. However, now that Fitch has downgraded Greece to BBB+ and S&P has placed it's A- rating on CreditWatch negative, there is considerable fear that if the ECB *does* tighten up its liquidity provision criteria at the end 2010, Greece may by then indeed have lost its A- rating from all three main ratings agencies. That could pose a problem for Greece, significantly reducing demand for Greek debt (the biggest holders of Greek debt are the Greek banks). And it would of course, pose a major threat to the profitability of the Greek banks as they would find their access to ECB liquidity significantly reduced.

## Ratings, Greek debt and the eurozone

Interest payments on Greece's national debt are expected to total almost 5% GDP this year, climbing to 6.1% GDP in 2011 and the European Commission estimates that 20% of the increase in debt since 2007 is due to interest costs. Compare that to the UK which will pay 3% of GDP in debt servicing costs. Add to that the fact that the cost of servicing the debt is not in Greece's control. The UK has boosted growth by allowing the pound to fall, has cut interest rates and the Bank of England has kept Gilt yields down by buying them in the market (QE). The ECB may increase rates which won't suit Greece at all. And the Bank of Greece cannot simply buy Greek debt. In joining the eurozone Greece gave away its monetary sovereignty, albeit in exchange for an implicit guarantee that the rest of the eurozone members would not standby and allow it to go to the wall. Without the option of boosting growth using the currency, or cutting rates (or indeed, even keeping them down), the Greek authorities are simply faced with the threat that any further deterioration in their finances causes the spread between Greek government bond yields and those elsewhere in the eurozone to widen further, from 226bp currently.

We have seen countries with large debt burdens before. And within the eurozone we've worried about Italy's creditworthiness. But what is particularly alarming here is that it is hard to see how interest costs can be lowered from here (policy rates cannot fall further and German government bond yields, the bellwether

	2008		Annual percentage change							
	bn euro	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	239.3		100.0	2.9	4.5	4.5	2.0	-1.1	-0.3	0.7
Unemployment rate (a)				9.9	8.9	8.3	7.7	9.0	10.2	11.0
Harmonised index of consumer prices				-	3.3	3.0	4.2	1.2	1.4	2.1
Current account balance (c)				-5.9	-12.8	-14.7	-13.8	-8.8	-7.9	-7.7
General government balance (c)				-6.6	-2.9	-3.7	-7.7	-12.7	-12.2	-12.8
General government gross debt (c)				98.1	97.1	95.6	99.2	112.6	124.9	135.4

(a) Eurostat definition. (b) gross saving by gross disposable income. (c) as a percentage of GDP.

Source: Eurostat

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for Europe, are almost at all-time lows). Meanwhile, nominal GDP growth is very weak and there is little confidence that a significant recovery can be engineered. If nominal growth is significantly below the interest cost of servicing the debt, the natural path of the debt/GDP ratio is to go higher. There simply is not an easy way around the problem, so the country faces either fiscal austerity or the prospect of further deterioration in the country's finances.

## **So what are the options and what is likely to happen?**

Tackling the ECB issue first, I personally don't think the ECB will act in such a way as to make a eurozone member's banks suffer. The return to a limit of A- for eligibility for repo collateral will be delayed.

That's just a minor detail, however. The big question is whether the situation is now so bad that confidence in Greece's fiscal credibility is impossible to rebuild. It probably hasn't gone quite that far yet but Greece is near to a downward spiral where loss of confidence sees investors shun Greek debt and Greek bank stocks, hurting growth and increasing the cost of servicing the country's debt.

It appeals to Anglo-Saxon commentators to put forward the idea that Greece could ultimately adopt an 'Alexandrian' solution and cut the knot by cutting free from the eurozone. In practise, we should probably expect a draconian 'austerity package' to restore the public finances, and some sort of *quid pro quo* from the eurozone to provide support. For the Greek people that means harsh cuts in public services and higher taxes.