

**ECONOMICS:** EUROPEAN PERSPECTIVES—FEBRUARY 5, 2010

# Greek Financial Woes Escalate but Default or Euro Departure is Still Unlikely

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The sell off in Greece this week has taught the country a tough lesson in the urgency of getting its debt under control. Although several risks remain and Greece may eventually require outside support, we believe it will not be allowed to fail, largely because of the risk of contagion to other weak euro-area countries.

The crisis in Greece has moved to a new level in recent days, with other euro-area countries coming under pressure and a spill-over into global equity markets. We continue to think that Greece will neither leave the euro nor default. Indeed, the last few days are a reminder of the systemic risks should Greece be allowed to fail.

Nor is it strictly right to think of Greece's problems as being entirely idiosyncratic. It may be the worst-placed euro-area country, and is certainly unique in the sense that it scores poorly on virtually all major risk indicators. But Greece's shortcomings are also evident in other euro-area countries. For example, all of the peripheral euro-area countries have seen their competitive positions deteriorate markedly in recent years (**Display 1**).

Fortunately, the situation is less urgent in the other peripheral countries. Italy has the highest government debt in the euro area but has kept its deficit under firm control in recent years and runs only a modest current account deficit. Ireland and Spain

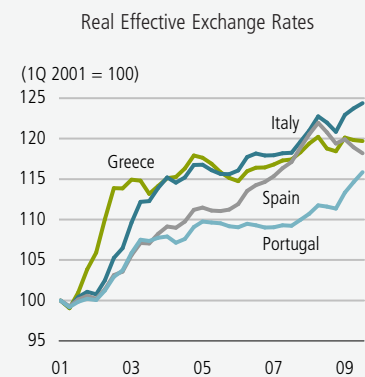
are trying to cope with the deflationary forces unleashed by collapsing asset-price bubbles. This has pushed their budget deficits close to Greek levels, but outstanding debt is much lower (**Display 2**). The same is true, to a lesser degree, of Portugal.

### Peripheral Countries in Spotlight

But even if these countries are not in as much immediate danger as Greece, the fact that they possess clear fundamental fault lines makes them vulnerable at times of heightened market stress. This helps explain why they find themselves the focus of unwanted market attention and why Greece, a country that accounts for just 2.6% of euro-area GDP, remains of such systemic importance.

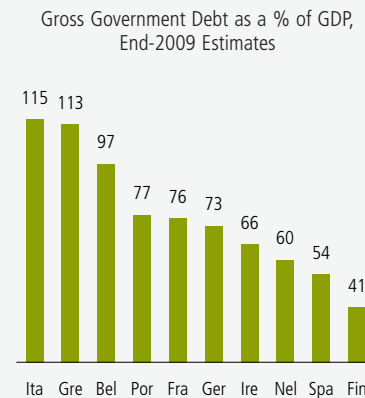
So where do we go from here? Over the last few weeks, there have been several positive developments. The recent market sell-off is unwelcome for many reasons. But at least it is succeeding where peer pressure and the European Union's institutional mechanisms have failed, in

Display 1  
All Peripheral Countries Have Lost Competitiveness



Source: European Commission and AllianceBernstein

Display 2  
Italy and Greece Have the Highest Government Debt



Source: European Commission, Haver Analytics and AllianceBernstein

forcing Greece to understand the gravity of the situation. Meaningful measures are finally starting to emerge.

We also welcome the firm stance adopted by the European Commission. Angered by years of prevarication, the Commission is no longer willing to take Greece's fiscal plans at face value. The implementation of the fiscal adjustment will therefore be subjected to unprecedented surveillance and potential intervention. All of the euro-area nations signed away their monetary sovereignty when they joined the euro. Greece may now have taken the first steps towards relinquishing its fiscal sovereignty.

### Important Risks Remain

But there are still considerable risks. The most obvious is implementation risk. There are two particular aspects to this. First, the austerity package could provoke a big domestic backlash. The evidence here is mixed. So far, opinion polls suggest that the government's popularity has not been unduly hurt by tough talk on the deficit. At the same time, several unions are planning industrial action—civil service (February 10); general strike (February 24); teachers (March 8). Notwithstanding the pressure from Brussels, there is a clear risk that the government will backtrack on some of its more unpopular proposals.

The second implementation risk relates to the scale of the task confronting Greece and the limited range of policy tools at its disposal. In the past, a number of European countries have reduced huge budget deficits. But, on most of these occasions, they were aided by weaker currencies and/or lower interest rates. Neither of these avenues is open to the Greek government and the market is, understandably, questioning whether or not it can deliver on its promises.

Even the basic mathematics of the stability program are challenging. The government

plans to reduce the budget deficit from 12.7% of GDP last year to 2.8% of GDP in 2012. This would see the debt-to-GDP ratio stabilize at 120.6% of GDP in 2011 and then start to decline. But these targets depend on fiscal adjustments equal to 4.0% of GDP this year, 3.1% of GDP in 2011 and 2.8% of GDP in 2012, nominal GDP growth of 3.5% per annum and little change in the average interest rate on the government debt. Most of these assumptions seem implausible.

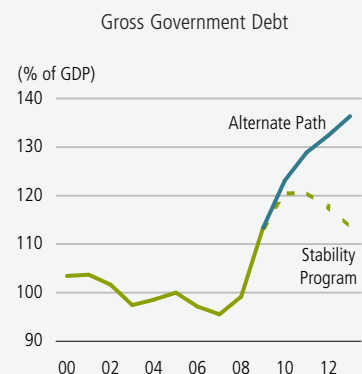
To see how vulnerable these projections are, let us assume that the government delivers 75% of its budget cuts, but that the fiscal tightening leads to nominal GDP growth being 1.0% per annum lower than in the stability program and that the interest rate on future government debt issues is 6.5%. Using these assumption, we estimate that the deficit would only decline to 7.0% of GDP in 2012 and that the debt-to-GDP ratio would rise to 132.4% (**Display 3**). This is why the European Commission wants to monitor the Greek fiscal position on a monthly basis, and why it has urged the government to make contingency plans.

The final risk relates to financing. On our estimates, Greece faces a gross funding requirement of about €55 billion this year. While this did not look too challenging a few weeks ago, it is likely to prove more problematic in the current environment. This is particularly true for April and May, where bond redemptions are clustered. The risk that Greece will need some form of outside assistance to get through this period has clearly grown.

### Conclusions

As stated at the beginning, we do not think Greece will quit the euro or default. This is not because we think its fundamentals are strong, but because of the systemic risks should it be allowed to fail. The fact that other euro-area countries are starting to weaken and equity markets are under

Display 3  
Debt Sustainability Relies on Optimistic Assumptions



The alternate path is based on the less optimistic assumptions mentioned in the text.  
Source: Greek government, Haver Analytics and AllianceBernstein

pressure, is likely to dampen the appetite of those wishing to make an example of Greece.

We should also recognize that the sell-off in Greece has been a necessary evil. Had the market continued buying Greek bonds at very low spreads, the chances of the government taking credible fiscal action would have been very low. To this extent, the recent sell-off may actually have been welcomed by the main European institutions. Now, with contagion spreading and Greece moving in the right direction, a more supportive approach may be required.

Finally, we need to consider whether this is a good time to invest in Greek government debt. After all, if Greece does not default or leave the euro, current yields look very attractive. The problem is that risks remain high. With no early resolution in sight, the market is likely to remain volatile and the situation could easily get worse before it gets better. In light of this, we will be maintaining a cautious stance towards Greece and the other peripheral euro-area markets. ■

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