Greece Crisis: A learning exercise for Public Debt Management

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Introduction

When a government raises loans internally or externally from banks, individuals and financial firms or world's monetary institution or from foreign government it incurs a debt (liability known as public debt). It is however, an instrument for temporarily augmenting revenue or purchasing power in exchange for an obligation (under a promise) on the part of the government to repay for principal sum borrowed plus a stipulated rate of interest on it at a specified future date.

While a government working under various constraints is often compelled to borrow, it may also reason to borrowing as a matter of deliberate policy. It is because public debt how the potential of playing a significant role in the development of an economy. As a practical expediency would be tolerated only for a while.

The efficacy of public borrowing internal and external should not be judged in isolation but in relation with their effects on the productive capacity. In case of external borrowing as the payment involves foreign exchange so its effects should be judges in relation with the foreign exchange earning capacity. But in doing so in addition to these effects it should also consider the problem of time reference or the opportunity cost involved in the borrowing programme.

Greece financial crisis is an example how, when the debt incurred to finance the current activities does not yield desired result will lead to derailment of the economy. As the world is integrated global factors played a key role in shaping the economy. Greece story is no different with integration of economies as model for development and common currency aiding the process the country could not able to manage its economy. The political leadership also over the period could not provide the desired direction.

In the pre-2008 era, availability of cheap debt was there but the problem was capital inflow was not used to help economy grow and it accumulated debt during the decade before the crisis when capital market were highly liquid. At the beginning of financial crisis shipping and tourism sector was affected by business cycle and debt began to pile up in the pre-crisis era.as the crisis got aggravated there was problem of raising fund and rating agency has downgraded it to junk status.

The financial crisis which started in 2008 has engulfed major economies of the world. The financial crisis also had a major impact on the Greek Economy. Greek which was part of European Union and with a common currency started feeling the brunt of it. This heightened the weaknesses in the Greek Economy which resulted in crisis among lenders. The fear that Greece ability to meet its debt obligation as the data on debt level and deficit has been misreported by the previous government. The Greek crisis has been termed as public sector indebtedness rather than private sector indebtedness. Most foreign banks and investors sold their Greek Bonds so that they can be vulnerable to crisis that had happened in Greece. Suddenly isolation from financial market also threatened towards bankruptcy will also lead to another financial crisis.

Greece were adversely affected by the crisis faced a strong rise in interest rate spreads for government bonds as a result of investor concerns about their future debt sustainability. From late 2009 on, after Greece's newly elected government stopped masking its true indebtedness and budget deficit, fears of sovereign defaults in certain European states developed in the public, and the government debt of several states was downgraded. In several countries, private debts arising from a property bubble were transferred to sovereign debt as a result of banking system bailouts and government responses to slowing economies post-bubble.

In Greece, the debt increase was associated with high public sector wage and pension commitments. The structure of the Eurozone as a currency union (i.e., one currency) without fiscal union (e.g., different tax and public pension rules) contributed to the crisis and limited the ability of European leaders to respond. When, as a negative repercussion of the Great Recession, the relatively fragile banking sector had suffered large capital losses, most states in Europe had to bail out several of their most affected banks with some supporting recapitalization loans, because of the strong linkage between their survival and the financial stability of the economy. The main root causes for the four sovereign debt crises erupting in Europe were reportedly a mix of: weak actual and potential growth, competitive weakness, liquidation of banks and sovereigns, large pre-existing debt-to-GDP ratios, and considerable liability stocks (government, private, and non-private sector).

Complex set of factor like globalisation of finance, real estate bubble, fiscal policy choices related to government revenues and expenses and approaches used by state to bail out troubled banking system and more fundamental imbalances within the Eurozone.

To avert this problem the International Monetary Fund, The European Central Bank and European Commission issued bailout package for Greece. The first bailout package amounting to $ 79 billion was given with a condition on economic policy. ECB provided substantial liquidity support to Greek Private Bank. The ECB also started buying Government debt from secondary market to reduce bond spread and to increase the confidence of investors. The major reasons attributed to the crisis are excessive expenditure, unregulated labour market, obsolete pension system, volatile capital market, Shipping and Tourism which were major contributors to GDP suffered due to crisis, strict norms from banks makes borrowings costlier.

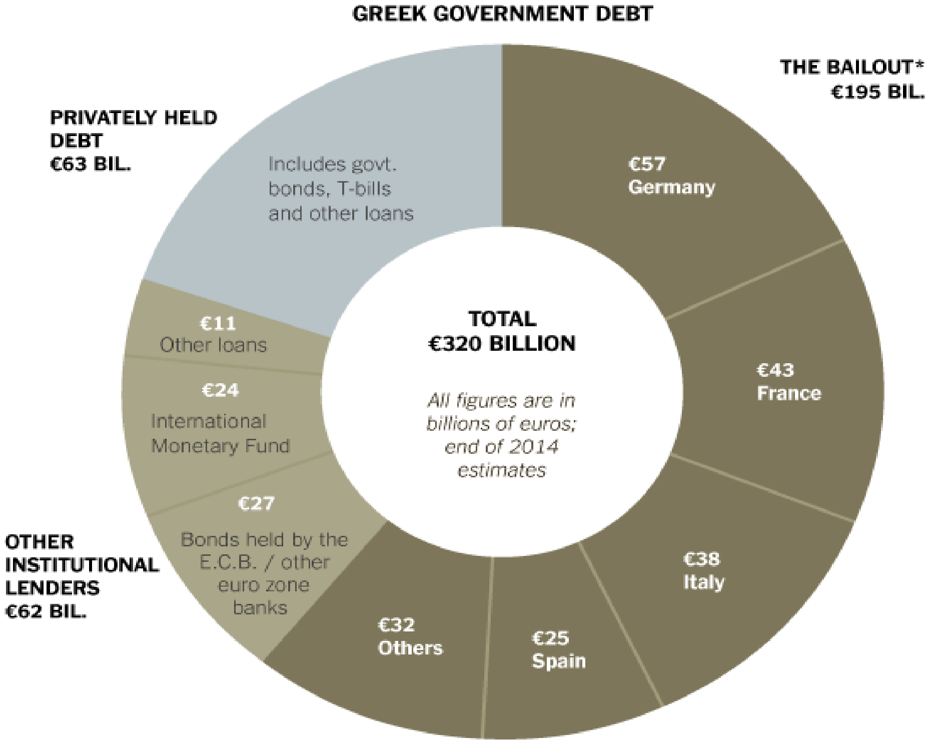
There were mismanagement between expenditure and revenue which was due to rising unemployment inefficient bureaucracy, Evasion of taxes and corruption. The fall in output has led to a steep fall in living standard and social condition. The unemployment rate increased from 8% in 2008 to 28% in 2013. Greece ran current above trade deficit averaging 9.1% GDP from 2000-2011.

According to International Corruption perception index Greece with a score of 36/100 ranked as the most corrupt country in the European Union. Overall the real GDP has fallen by over 27% since the depression began. A sizeable portion of the bailout funds were towards serving Greek debt. The weakness of the banking system means its reliance on European Central Banks for emerging funds. The bank balance sheet was plagued with high level of non- performing loans. Banks were shut for three weeks and capital control where introduced in late June in order to stop Greek bank running out of money.

Increment in service payment must be met out of increased nation income. If on the other hand, the incidence of service payment falls on current income, domestic consumption and investment will be adversely affected and free growth of the economy will be jeopardized. Therefore, a continuous rise in national income and per capital income is one of the important condition for the successful debt servicing.

Greece was bailed out in 2010 with a 110 billion euro direct loan by the European Union and the International Monetary Fund. After 2 years of fiscal austerity and Greek riots, another 130 billion euro loan was made. Greek austerity programs greatly reduced public pensions and public wages

Chart 1



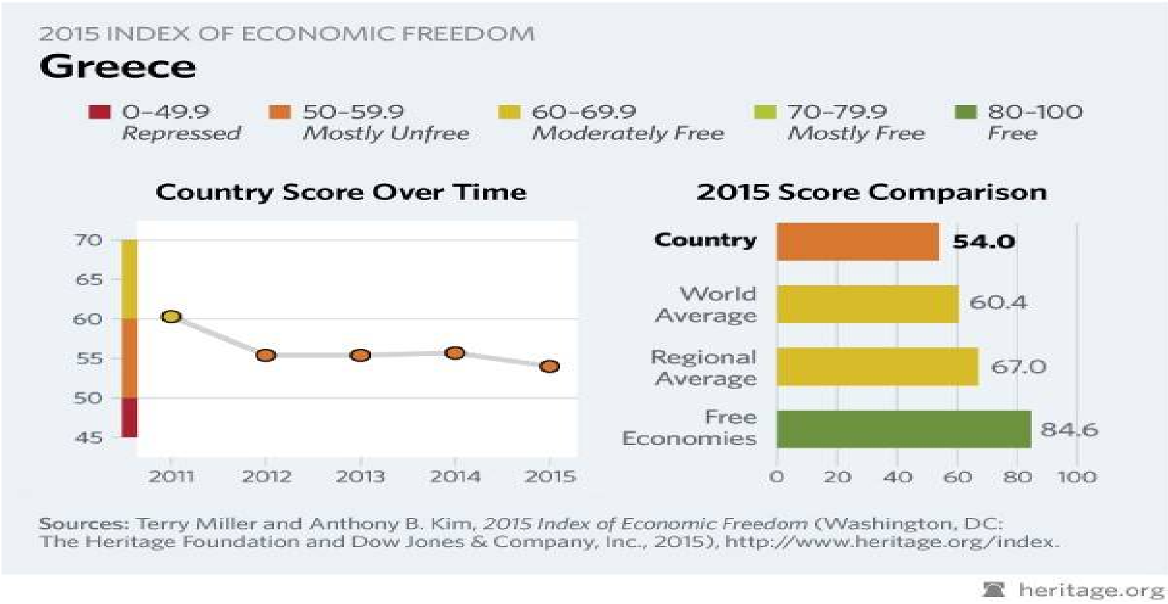
*European countries lent to Greece through two newly created institutions — €53 billion through the Bilateral Loan Facility and €142 billion through the European Financial Stability Facility. These are in addition to each country's contribution to the I.M.F.

Sources: Deutsche Bank; I.M.F.; Reuters; Bloomberg

Chart 1 depict the composition of debt which in a way also put thrust on management of public debt which if not managed properly will result in immediate problem of meeting the debt service charges on the existing debt. Export promotion and import substitution are necessary for narrowing the deficit in the balance of trade of the country. But equally important are the internal economic adjustment which are needed for achieving balance in International Transaction.

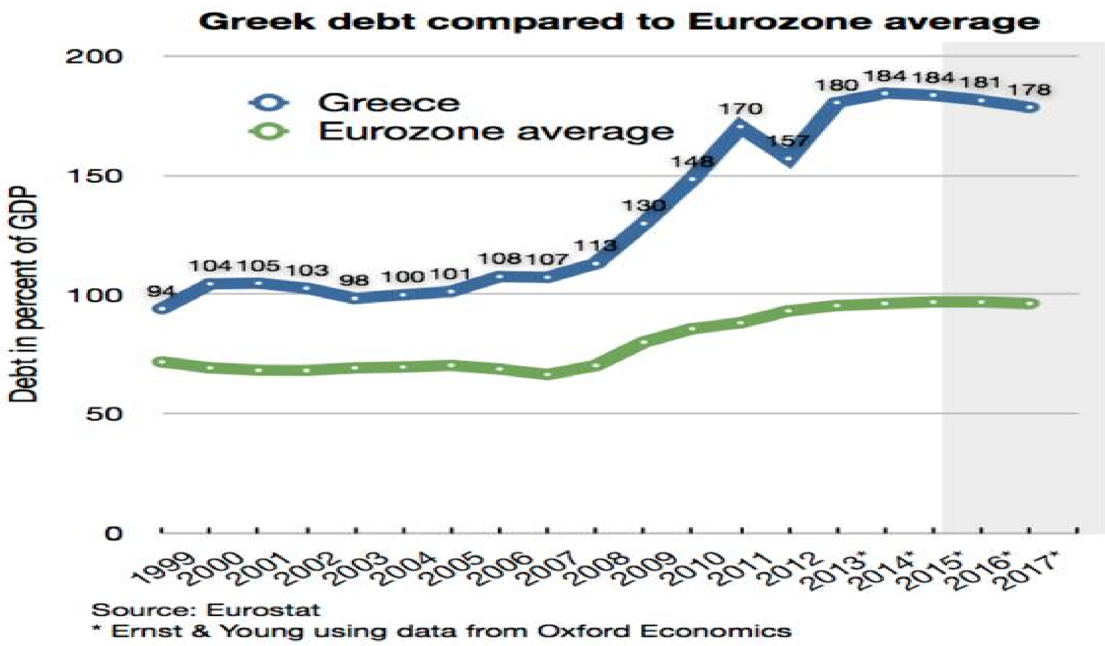
While accepting the need for reducing the burden of the existing debt it is necessary to emphasize the liabilities of the debtor countries. They have to show a good progress report of the utilisation of foreign capital in their economies.

Chart 2



Greece with a score of 54.0 is the 130th freest in the 2015 Index of Economic freedom. Its score has declined due to detoriation in the control of government spending. The other reason attributed to is public debt crisis and the implication of international bailout packages. The detoriation in business environment and failure to adjust to the crisis are also the major factors in reduction in the index of economic freedom.

Chart 3



The above chart depicts Greek debt to Eurozone Average. The chart shows how over the period Greece debt has shown a continuous rising trend. This will also require servicing and repayment of debt which will put strain on the economy if it is not supported by increase in growth rate.

India and Greece

As India is not directly exposed to Greece in terms of trade ties it is less likely to affect India. Export will suffer due to crisis and India has to bear the consequences. Foreign Investors will relocate their portfolio which will result in inflow and outflow of capital out of India. However the strength in India's economy and hopes of further reform may convince foreign investor to not exit country in a hurry. India's software and Engineering export may take a hit. Engineering exporters body EEPC India said the economic crisis in Greece will impact engineering exports from India as European Union is the largest destination from such shipment. RBI Governor Raghuram Rajan has said the Indian Economy will see through any impact of the Greek crisis. Robust forex reserves will cushion any possible impact of the crisis.

Recent Initiative and Way Forward

The Greek government held a referendum on the terms of the deal offered by the creditors. This was the first time a developed economy had ever defaulted on a loan from the IMF Banks were shut for three weeks and capital control were introduced in late June in order to stop Greek banks running out of money. Following the 12th July agreement in principle for third Eurozone bailout agreement the ECB raised its emergency funding for the Greek banking system. A provisional agreement was struck on a third bailout programme for Greece which could total up to $86 billion in loans over three years Under the terms of agreement Greece is to implement a reform agenda including changes in the Pension system and market based reform of the economy and to make it more competitive. Greece is required to pay $3.2bn debt repayment to the European central bank. Greece cleared its arrears to IMF and other debt to be cleared in 2015.With the fresh round of election declared and incoming govt. will take all concerted effort to work on the structural deficit, revival of market sentiment, creation of demand and reduction of unemployment.

Conclusion

Excessive borrowing apart from increasing the tax burden of future generation can also increase internal rates thus making private investment more expensive. If the cost of servicing debt accounts for a larger part of Government Revenue then funds available for items like health, education and infrastructure get reduced. It is therefore essential for countries that not only is the level of debt kept with sustainable crisis but its cost composition and risk profile is managed efficiently.

Contribution of the external Public Debt to the economic development of the Country should be taken into consideration while assessing the burden of external debt servicing. Therefore, external bailout package also involves major restructuring exercise to be done to avoid the problem both in the short run and long run.

The theory of capacity to serve external debt is unlikely to be developed until the basic issues in the theory of economic growth have been resolved. There is wide agreement among well-known expert the basic long term aspect of debt servicing capacity is inseparable from the general problem of economic growth resulting in continuing growth in per capita output and rapid formation of capital. Debt servicing capacity upon the rate of growth of the national income of the borrowing country. The service Payment are met out of the national income and therefore the national income and per capita income must rise satisfactorily so that the larger service payment may not affect the consumption level in the country. Greece should work on the structural reform which will sustain the growth momentum and pull the economy out of the crisis. It is also a learning exercise for country like India to manage their Public Debt so that in future any short of crisis can be avoided.

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