



## Market Musings

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### Framing the Greek Crisis for Canada

This report provides a brief overview of the Greek fiscal crisis, framed for a Canadian perspective. It is a subject that has attracted great attention, and represents the largest single risk to the global economic recovery.

#### Root Cause

There are two root causes of the fiscal crisis that is now sweeping across Europe.

First, the credit crunch obliged governments around the world to run large deficits. The accompanying recession activated automatic stabilizers that boosted spending at the same time that revenue naturally faltered. Bank bailouts and stability programs also cost money. Even in the recovery, deficits will persist for several more years in most countries.

Second, the 1999 creation of the euro and the centralization of monetary policy at the European Central Bank created a unique opportunity for Southern European nations to borrow. They had historically been confronted with high borrowing costs that reflected their tendency to run persistent deficits and sporadically devalue their currencies. With their entry into the euro, they were suddenly granted access to borrowing rates similar to that of Northern Europe. The temptation to spend was great, and deficits began to balloon.

#### The Quandary

Unlike in the pre-euro era, Southern European nations no longer have their own currency or monetary policy, and so they cannot devalue or inflate their way back to a competitive position.

In the Greek case, the size of the deficit was substantially underestimated for many years, and has only recently been revealed to be far larger than previously imagined, on the order of about 14% of GDP. In turn, the problem snuck up on almost everyone.

Markets have now grown weary of rewarding such fiscal largesse with low borrowing costs. The bond market has recently begun to price a significant chance that Greece will be unable to meet its debt obligations. Interest rates have soared, with the Greek 2-year borrowing rate peaking at over 18%.

Unfortunately, there is a vicious-circle aspect to the problem. The higher the borrowing cost becomes, the more of a burden it is to Greece, and the deficit expands further. Greece is now nearing a breaking point, and will not be able to finance its borrowing needs over the next month without external help.

#### The Only True Solution

When you spend more than you earn, there's only one solution – to spend less or earn more. The Greek government has some capacity to earn more by increasing taxes, but a pervasive culture of tax evasion will limit this. Spending cuts are the more promising option, but have been met by resistance from unions and other interest groups. In turn, it is difficult to imagine Greece rapidly returning to a balanced budget. Examples like Canada in the mid-1990s provide a textbook example of how to correct significant deficits, but even there the deficit was only half as large as Greece and the process nonetheless took four years to complete.

#### Near Term Patch

The near term patch is that the IMF and Europe will collectively lend as much as 120Bn euros to Greece, providing it with up to three years of breathing room to enact austerity measures. This proposal has begun to fray around the edges, but should nonetheless hold. Of course, this is not a permanent fix – it is still necessary for

Greece to work its way back to a balanced budget or the same problems will recur a few years down the line. The current wrangling over the specific nature of the loan package – while not good for the market's confidence – has the effect of nudging Greece towards additional austerity measures.

## Alternatives

Several other scenarios have been bandied about in the market. None are perfect solutions:

**Blanket Default:** A blanket default in which Greece were to throw up its hands and walk away from the entirety of its debt would not fix the problem. Greece currently pays interest costs of about 5% of GDP on its debt. As such, post-default Greece would still be running a deficit of about 9% of GDP. The difference is that financial markets would then be closed to Greece for many years, meaning that the rest of the deficit could not be financed in any way. In turn, extremely severe austerity measures would be needed to bring Greece back to a balanced budget immediately. This is not an attractive option.

**Restructuring:** A restructuring of Greece's debt is another option. It would technically qualify as a debt default, though the outcome would not be as severe for bondholders. Greece could elect to honour only a portion of their debt, perhaps 30-70% of the face value. Alternately (or additionally), Greece could extend the term on existing debt such that short-dated bonds become long-dated bonds, putting off the need to roll the debt. Again, however, this does not provide a perfect fix to the problem. It might reduce the Greek deficit by 2-3% of GDP and slash the burden of rolling existing debt, but a sizeable deficit would persist. The hope would be that the bond market might be understanding of the restructuring, permitting access once more to debt financing. This is possible, but hardly certain.

**Abandon Euro:** Abandoning the euro altogether is not a great solution for Greece, either. Although it would allow Greece to depreciate its currency and run stimulative monetary policy, it also brings significant complications. The cost of borrowing in Greece was historically even higher outside of the euro than it is right now. For instance, prior to 1995 the Greek 10-year bond regularly posted a 20%+ yield. In the present environment, not only would the cost of borrowing remain extremely high but the market might refuse to lend to Greece in the local Greek currency, creating an even heavier burden for Greece given the presumption of a depreciating currency. From a practical perspective, it is also not at all clear how Greece would exit from the euro as there is no mechanism for this. Even for the rest of the European nations, this would be an undesirable blow to the credibility of the euro and its importance on the global stage.

## Economic Risk

The direct economic consequences that arise from Greek fiscal problems are not that large. The Greek economy is only 2% of Europe's economy, meaning that even a sharp economic correction will not necessarily have much impact on the continent-wide growth rate, let alone that of the world.

European GDP could even accelerate as a consequence of the financial crisis, as the euro is falling sufficiently quickly that the healthier European nations may enjoy very robust economic growth versus the rest of the world.

## Financial Risk

Arguably the greatest risk from the Greek fiscal crisis is financial in nature. Many foreign banks hold Greek debt, and a default would prompt significant losses across Europe (and to a lesser extent, around the world). Greece has 299Bn euros in debt.

For banks to lose their share in a blanket default would obviously be quite painful, though it does not present a systemic risk. All major European banks have been calculated to have enough capital to withstand their exposure to Greek debt.

The systemic risk begins to grow when the possibility of default by several countries are combined together. In a worst case scenario, if Greece, Portugal, Spain, and Italy were to all default on their debt, that would be a significantly more serious proposition. It does not appear to be an especially high probability event at present, but nor is it inconceivable.

Together, the four countries have 2,619Bn euros in debt. This is a size with potentially systemic consequences. However, the impact should not be as large as the just-ended credit crunch. For one, assuming a recovery rate of 50%, the potential loss is more like \$1,300Bn. This is only a little more than half the IMF's predicted losses for banks from the credit crunch. Moreover, banks have learned from the crunch to reduce their counterparty risk and bolster their capital, governments have developed frameworks to keep financial markets liquid, and there is a widespread appreciation for the importance of protecting entities that are "too big to fail". Few banks would have the same intensity of exposure to Greek or Southern European bonds that they had to U.S. mortgages. Rather, the exposure would be more evenly distributed, and many of the banks with the largest exposures are quasi-governmental institutions. Greek debt is far less opaque than the collateralized debt obligations and their ilk of the credit crunch, and so uncertainty would not cloud the market's thinking for as long, either.

Another way of constructively thinking about the European fiscal problem is that the Eurozone debt-GDP ratio is only 66%. This is below the U.S. equivalent of 83%. That's another way of observing that the European economic engine is large enough to handle the debt burden, it's just that the debt is not spread smoothly across nations. While a smooth redistribution does not seem likely, suffice it to say that the worst-case systemic scenario can be avoided via the transference of debt burdens among Eurozone nations. In fact, European nations would have a choice. They could either directly bail out the countries involved, or they could allow the countries to fail and then bail out their own banks, as needed. Either one will suffice, though the first is preferable.

Nonetheless, a significant deterioration in other southern European nations would contribute to a further widening of credit spreads, reducing the willingness of banks to lend. This would be a mini-version of the events of the fall of 2008, with the result that economic growth would presumably also be affected.

## Canada Implications

The Canadian implications of the Greek fiscal crisis should be relatively tame, and Canada is among the most peripheral of players in the crisis.

The direct economic implications should be virtually nonexistent given a trivial amount of trade between Greece and Canada. Similarly, Canadian banks and investors do not appear to hold significant amounts of Greek debt.

The greater concern is via financial contagion. Just as Canada was sucked into the credit crunch despite very little affiliation with the underlying problems, Canada could well be sucked into a European fiscal panic via financial market variables. For instance, bank credit spreads have begun to march outwards as the market prices in the risk that a Greek default could impact the bottom lines of certain banks. Even for banks without a significant exposure to Greece, the risk that counterparty banks or investors were exposed would increase the cost of borrowing for Canadian banks, and in turn engender some reluctance to lend.

More generally, as the market turns its attention to fiscal matters, some countries will be tarred by this brush. Canada is unlikely to be among them due to its healthy fiscal finances. To the contrary, some investors could shift their investments towards a country of relative safety like Canada. Nonetheless, it remains clear that the U.S. is still perceived by the market as the ultimate safe haven.

Should market concerns intensify, the Canadian dollar would likely fall versus the U.S. dollar, and commodity prices would decline modestly. Canadian equities would dip in synchronization with the rest of the world as investors favoured the safety of bonds. In an extreme scenario, the Bank of Canada's plan to raise interest rates could even be kiboshed, as global economic prospects might diminish significantly should systemic risks start to be tripped.

However, the magnitude of the crisis – though potentially large – seems unlikely to match that of the just-finished credit crunch. This provides some small reassurance, but it is undeniable that the market has re-entered a period of significant volatility, with sizable tail risks given the many permutations at play.

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