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Debt: The Greek Crisis

Dr Geeta Lakshmi, Senior Lecturer in the Lincoln Business School, considers the predicament of the Greek sovereign debt crisis: Sovereign debt is not a zero sum game: everyone takes on the pain. The question is how much more the Greeks are prepared to take in the form of austerity measures. As the country is perched […]

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Dr Geeta Lakshmi, Senior Lecturer in the Lincoln Business School, considers the predicament of the Greek sovereign debt crisis:

Sovereign debt is not a zero sum game: everyone takes on the pain. The question is how much more the Greeks are prepared to take in the form of austerity measures. As the country is perched on the precipice of default, it is looking at offers to stave off default. All of them come with conditions of shared pain. Greece might prefer to default and write off some of the debt as any further offer would come with additional debt service obligation, but any rollover would be accompanied by more promises of stringent public spending. On the other hand, it is simply impossible to look away and pretend the problem does not exist.

Systematic Shocks

It used to be said that when USA sneezed, the rest of the world caught a cold.

Growing systemic risk has ensured that if relatively minor economic sovereign countries like Greece dally with the notion of default, the rest of us fear the cold will turn into viral flu.

Globalisation has made it inevitable that regional ills have the ability to spin around the markets. Deregulation of banks and stock markets has also meant that these actors are transmission agents; but the main contagion factor in the case of Greece is the unified currency of Euro. It is therefore not just Greece's problem anymore. The Euro has a taken a hammering of late and worries are that a write-off might even kill the Euro. France and Germany are concerned and the other countries that have been caught in the web of high borrowings such as Portugal and Italy are also affected.

Fears of systemic risk have affected Australia's markets, which fell. Reverberations have been felt as far away as the Asian markets with Japan's Nikkei and South Korea's Kospi showing signs of more than sniffles. This malaise is so pervasive that despite not being legally obliged to rescue Greece, the UK is also affected due to its trade and banking links, despite the vociferous statements made by David Cameron.

Meanwhile, inadvertently the Greek debt has cast shadows on the financial prudence of other countries. Nations have grown in the past few decades on the basis of debt undertaken by state borrowers to fund infrastructure. However, unlike corporate borrowers, sovereign borrowers appear to have more diplomatic immunity and some of these divert debt borrowings to unproductive uses. Unlike corporate borrowers, sovereign borrowers find it easier to hide unproductive deals or cronyism over economic gain. Debt itself is not the problem because interest on this should be paid out of return on investment. However, where the return on investment is less than the interest on borrowing, clearly debt becomes unsustainable.

The Panacea

France, whose banks have large exposure to Greek debt, have agreed that they are prepared to roll over long term Greek debt for a rate equal to the lending rate plus a premium based on Greece's growth. Germany has shown some interest in this model. The Premier of China has signalled that China is considering bailing out debt ridden countries, perhaps Greece, and has signalled that it might lend a helping hand. While others are selling off the debt, China is considering taking on more debt, signalling its confidence in the future of Europe. It might do so by buying state assets or crown jewels of Greece. While the squeeze on the Grecian populace is getting tighter, the rest of the world knows that specific risks can easily become systematic and it is important to be sustainable. Should state assets fall into the hands of the French, German or Chinese, it would be wise to instil financial rigor in running such firms. Fitch, as a rating agency, has played its part by promising to keep Greek debt at CCC grade rather than default, thus allowing the major supranational bank ECB to hold the debt as collateral.

The Current Picture

In recent days, bid yields on long term Greek debt have hit the 20% mark, up from less than 10% a year ago. The following diagram shows the evolution of the bid yields on sovereign bonds held by China and Greece. (Bid debt yields though strictly not comparable due to different maturities and coupons, show an interesting time series pattern: note the relative stability of Chinese yields over the almost steady climb of Greek bid yield.)

Bid Yields of Republic of Greece, 3.6%, 20/7/2016 vs. Bid Yields of People's Republic of China, 4.25%, 28/10/2014

(Source: constructed from data collected from FT)

So what are the options for Greece? Very little it appears. If it chooses to default, restructuring will cause unhealthier movements in the Euro, which has been a popular reserve currency held globally. Banks will have to write off more debts causing a domino effect. The ECB, which has a large exposure to Greek debt, will have to worry about its portfolio and private bond holders will face more haircuts.

If banks are too big to fail, can the same be said about currencies and nations? It would appear so, as demonstrated by a worried IMF and the rest of the world.

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