February 5, 2010

# Economics Group

Special Commentary

**Jay Bryson, Global Economist**
jay.bryson@wachovia.com ● 704-383-3518

# The Long Road Ahead for Greece (and Others)

## Executive Summary

Global financial markets have been rocked recently by concerns about the fiscal situation in Greece. To its credit, the Greek government has put forth an ambitious plan to sharply reduce its deficit over the next few years. Even with a significant fiscal correction, however, the debt-to-GDP ratio of the Greek government will continue to rise if nominal GDP growth remains sluggish. But how does the Hellenic republic pull off the trick of making a sizable fiscal correction while at the same time boosting nominal GDP growth? Given its fixed nominal exchange rate with the other members of the euro area, it will be difficult for Greece to export its way back to prosperity via exchange rate depreciation.

In our view, there is a significant probability that the International Monetary Fund (IMF) will need to extend a lending package to Greece to help smooth out its adjustment. Given the significant resources that the IMF has at its disposal at present, a package for Greece would not break the IMF. The fiscal situations in Portugal and Ireland are not as dire as they are in Greece, but both countries could go hat in hand to the IMF, although probably not necessary, without putting undue strain on the IMF. In other words, the IMF has the resources available, if necessary, to help stabilize the financial situation in some Euro-zone economies. However, Spain is one of the 10 largest economies in the world, and any IMF package for that country would need to be sizable given the sheer size of the Spanish economy. If, in the unlikely event, the IMF needs to come to the simultaneous rescue of the four Euro-zone economies with the worst fiscal situations, the IMF's ability to help other countries may start to be compromised.

## How Did Greece Get Here?

Greece has made headlines in the world's financial press recently due to investor concerns about the government's current fiscal situation and its long-run outlook, and these worries have been manifested in a sharp increase in borrowing costs for the Greek government. For example, the yield on the 10-year Greek government bond, which had been as low as 4.40 percent last October, has shot up to more than 6.70 percent as of this writing. Before the global financial crisis started in mid-2007, the Greek government needed to pay only 20 bps more than the German government to borrow for 10 years. Today, that spread has blown out to more than 360 bps.

***The fiscal deficit of the Greek government has exploded recently.***

The debt situation of the Greek government has been the catalyst for the current crisis. The government's debt-to-GDP ratio, which fluctuated between 95 to 100 percent throughout most of the past decade, has jumped up to about 110 percent at present and, as we discuss later, further increases lie in store (Figure 1). The government has incurred red ink for years, but the explosion in its fiscal deficit from about 6 percent of GDP in 2008 to nearly 12 percent at present has caused debt to rise sharply over the past year. Not only did expenditures climb as the government tried to cushion the blow from the deep recession, but the downturn in the economy also caused revenue to stagnate (Figure 2). So where do we go from here?

**Figure 1**

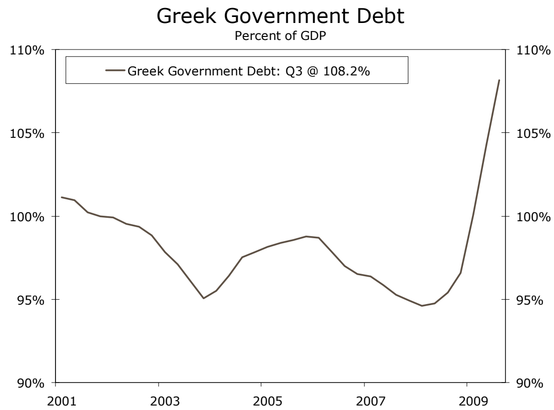
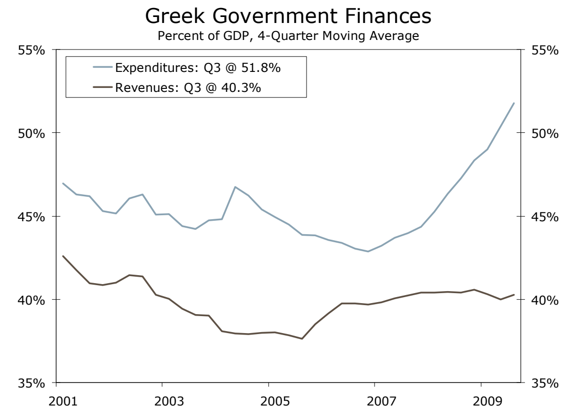



**Figure 2**




**Source: Eurostat and Wells Fargo Securities, LLC**

## Fiscal Adjustment: A Daunting Task

The dynamics of the government's debt in future years depend on the paths of nominal GDP growth, interest on government debt and the fiscal deficit.[1] The Organisation for Economic Cooperation and Development (OECD) forecasts that Greece will eke out a nominal GDP growth rate of 1.5 percent in 2010. The Greek government is currently paying 6 percent per annum or more on most maturities of its bonds, and the size of the government's deficit at present is nearly 12 percent of GDP. If these variables remain unchanged in the years ahead, then the debt-to-GDP ratio of the Greek government, which currently equals about 110 percent, will shoot up to 200 percent by 2015 and to more than 300 percent by 2020 (Scenario 1 in Figure 3). Clearly, the debt dynamics of the Greek government are not sustainable at present.

***Without strong nominal GDP growth, it will be difficult to stabilize the debt-to-GDP ratio in Greece.***

What needs to happen to stabilize the debt-to-GDP ratio?[2] The Greek government has promised the European Commission that it intends to reduce its budget deficit from approximately 12 percent of GDP today to only 2.8 percent by 2012. This drastic adjustment would help to slow down the rate of increase in the debt, but it is not sufficient to stabilize the debt-to-GDP ratio. Even if the Hellenic republic makes good on its promise to dramatically reduce its deficit, the debt-to-GDP ratio would still grow beyond 200 percent by the last years of this decade if nominal GDP growth remains depressed at 1.5 percent per annum and interest payments on government debt remain elevated (Scenario 2 in Figure 3). Only if Greece makes its promised fiscal correction *and* nominal GDP growth returns to its 2004-2007 average of 7.1 percent *and* interest rates fall to the 2004-2007 average of 4.7 percent would the debt-to-GDP ratio stabilize at 130 percent, about 35 percentage points above precrisis levels. (Scenario 3 in Figure 3) How likely is it that the Greek economy bounces back to "normal" in the next few years?

The cases of Finland and Sweden, which each experienced painful financial crises in the early 1990s, are instructive. Both Finland and Sweden were able to pull of fairly significant fiscal corrections—about 7 percent of GDP in the case of Finland and 10 percent in the case of Sweden—but each country needed three or four years to achieve the correction rather than just two years as Greece hopes to do. In addition, each country was able to return to nominal GDP growth rates that were close to precrisis rates within a few years after their respective crises. Rather than relying on higher inflation to pump up nominal GDP growth rates, strong rates of real GDP growth resumed in both Finland and Sweden by the mid-1990s. Both Finland and Sweden were

**[1] For a technical discussion on debt dynamics see, for example, Christian Broda and David Weinstein, "Happy News from the Dismal Science: Reassessing Japanese Fiscal Policy and Sustainability," National Bureau of Economic Research Working Paper #10988, December 2004.**

**[2] The economic literature generally defines fiscal sustainability as a situation in which the ratio of debt-to-GDP eventually returns to its initial level. See Olivier Blanchard, Jean-Claude Chouraqui, Robert Hagemann and Nicola Sartor, "The Sustainability of Fiscal Policy: New Answers to Old Questions," OECD Economic Studies #15, 1990. In this report, however, we define stability as a situation in which the debt-to-GDP ratio simply stops rising.**

able to achieve strong growth in real GDP through the assistance of double-digit growth rates in real exports during the mid-1990s. However, even under the fairly benign economic conditions that Finland and Sweden faced, their respective debt-to-GDP ratios remained elevated for years.[3]

**Figure 3**

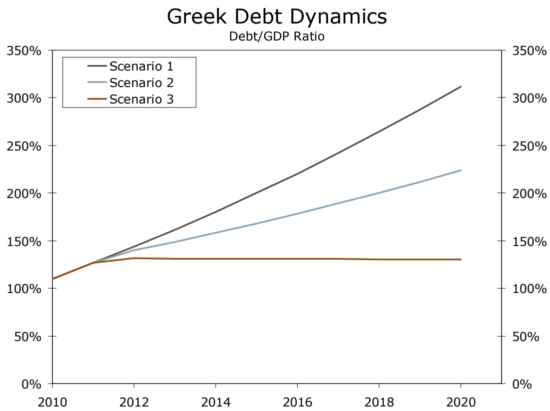
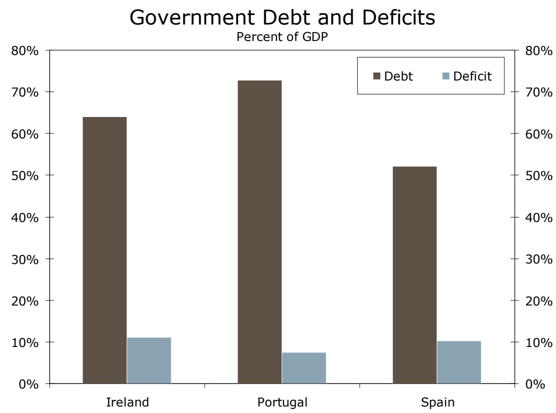



**Figure 4**




**Source: Eurostat and Wells Fargo Securities, LLC**

***It will be difficult for Greece to export its way back to prosperity.***

Greece likely will have a much more daunting task than either Finland or Sweden. For starters, the Hellenic republic probably won't be able to export its way back to prosperity as easily. Finnish and Swedish exports were boosted in part by the 25 to 30 percent real depreciations of their currencies in the aftermath of their crises. In contrast, Greece shares a common currency with the other 15 members of the euro area, to which roughly 60 percent of Greek exports are destined. The only way to bring about a real depreciation in Greece if the nominal exchange rate is more or less fixed is through a painful deflation or a significant decline in unit labor costs.[4] Another way to lift nominal GDP growth is via inflation. This option is not available to the Greek central bank, however, because monetary policy in Greece is set by the European Central Bank. In our view, it is inconceivable that the inflation-focused ECB would tolerate a high inflation rate in the overall Euro-zone simply to help the Greek government alleviate its debt burden.

Greece's avowed determination to address its fiscal situation is admirable, but a fiscal contraction of 8 percent of GDP over two years very likely would lead to another downturn in the Greek economy. And as noted earlier, a fiscal correction alone is not enough to stabilize the government's debt-to-GDP ratio. A return to "normal" GDP is also required to bring about stability in the ratio. How does Greece solve the problem of making the required fiscal adjustment while at the same time supporting nominal GDP growth?

## IMF to the Rescue?

***Greece may need an IMF package to smooth out its adjustment burden.***

In our view, there is a significant probability that Greece eventually will be forced to seek financial assistance from either the European Union and/or the IMF. The significance of Greece's public declaration to implement an onerous fiscal adjustment, and the subsequent acceptance of the proposal by the European Commission, is that it gives officials in the European Union and the IMF the cover they need to eventually come to Greece's rescue. If Greece is seen to be doing its part to correct its problems, then either the European Union or the IMF can lend a helping hand. Of course, strings will be attached to any lending package starting with credible audits on a going-forward basis of the fiscal situation in Greece. Eight percent of Greek GDP is about €20 billion

**[3] The debt-to-GDP ratio of the Swedish government rose from 50 percent before the crisis to more than 80 percent in the late 1990s. It did not return to pre-crisis levels until 2007. Finland's ratio rose from less than 20 percent before the crisis to about 65 percent in the mid-1990s. It declined to 40 percent in 2008 but has subsequently risen to more than 50 percent at present.**

**[4] For a discussion of the problems that Greece and some other countries in the euro area have in adjusting their real exchange rates see our special report entitled "The Long Road Ahead for 'Club Med' Countries" (March 18, 2009) that is available from the author upon request.**

(almost $30 billion at current exchange rates). In a worst case scenario, the IMF would need to cough up €53 billion, which represents the debt the Greek government needs to rollover this year (assuming investors completely refuse to buy Greek debt, which isn't very realistic if an IMF rescue package were forthcoming). The IMF currently has about 225 billion SDRs (roughly €250 billion or $350 billion at current exchange rates) in its coffers at present. Thus, a rescue package for Greece would not break the IMF.

## Are There Other "Greeces" in the Euro-zone?

***Ireland, Portugal and Spain also have precarious fiscal positions.***

Unfortunately, Greece is not the only country in the Euro-zone that has fiscal issues at present. The other three countries in the euro area with the most precarious fiscal situations currently are Ireland, Portugal and Spain.[5] Each country has seen its fiscal deficit balloon in the past year or so to more than 10 percent of GDP at present (Figure 4). However, the government debt-to-GDP ratios for both Ireland and Spain were relatively low before their economies fell into deep recessions—25 percent for the former and 35 percent for the latter—so both governments have some room to run up their debt. Although government bond yields in both Ireland and Spain have backed up recently, the increases have been far less extreme than in Greece due to the stronger fiscal positions of the Irish and Spanish governments, at least relative to the government of the Hellenic republic.

***The IMF would have the resources available to support Portugal, if needed.***

Portugal's fiscal position is not quite as bad as Greece's, but it is not as good as Ireland's and Spain's. The debt-to-GDP ratio of the Portuguese government was roughly 60 percent two years ago, but the ratio has subsequently climbed to more than 70 percent as the deficit has widened to about 8 percent. Because the required fiscal adjustment in Portugal is not quite as herculean as it is in Greece, the need for an IMF package in the former is not quite as great as in the latter. However, the IMF would have the resources available to support Portugal, if needed. Not only is the necessary fiscal adjustment in Portugal smaller than in Greece—about 5 percent of GDP versus 8 percent—but the Portuguese economy is not as large as the Greek economy.[6] Thus, the IMF would probably need to pony up less money for Portugal than it would for Greece.

Spain is a different kettle of fish. As noted above, the fiscal situation in Spain is not quite as bad as it is in Portugal, let alone as it is in Greece, and the Spanish government recently announced plans to bring its fiscal deficit down to 3 percent of GDP by 2013. In addition, investors don't seem as nervous about Spain as they do about Greece. Since October, the spread of the 10-year Spanish government bond over the 10-year German government bond has widened by 40 bps. The comparable spread for Greece is out 240 bps over that period.

***Due to the sheer size of the Spanish economy, any IMF package for Spain would need to be sizeable.***

However, Spain is attempting to pull off a fiscal adjustment worth 5 to 6 percent of GDP, which is not an easy task in an economy that has already experienced a 5 percent contraction in real GDP and has seen its unemployment rate soar from 8 percent two years ago to 19 percent at present. Moreover, as with Greece, Spain will find it difficult to export its way back to prosperity because other countries in the Euro-zone account for more than 60 percent of Spanish exports. Although Spain may not need an IMF package as badly as Greece does, the Spanish economy is four times as large as the Spanish economy. An IMF lending package for Spain could easily run to €50 billion–€60 billion. The probability is rather low that the IMF will need to simultaneously come to the rescue of Greece, Portugal and Spain. In the event that it does need to do so, however, the IMF's ability to help other countries may start to be compromised.

## Conclusions

The fiscal situation in Greece is clearly not sustainable. To its credit, the Greek government has put forth an ambitious plan to sharply reduce its budget deficit over the next few years. However, accomplishing its goal will be a daunting task. For starters, trade unions are planning general strikes to protest the austerity measures. In other words, significant political opposition already exists to the government's plans. Moreover, the government will need to keep nominal GDP growth buoyant to keep the debt-to-GDP ratio from spiraling ever upward. However, it will be difficult for Greece to export its way back to prosperity via exchange rate depreciation due to the

---

**[5] Italy's debt-to-GDP ratio exceeds 110 percent, but its deficit is less than 5 percent of GDP at present.**
**[6] Nominal GDP in Portugal totaled about €160 billion in 2009. The size of the Greek economy last year was about €250 billion.**

common currency it shares with the other Euro-zone members, to which it sends the majority of its exports. In our view, there is a significant probability that the IMF will need to come to the rescue at some point this year to help the Hellenic republic smooth out its adjustment path. Given the sizable resources that the IMF has at its disposal at present, a lending package for Greece would not break the IMF.

Portugal, Ireland and Spain are in better positions, at least on a relative basis, because their debt-to-GDP ratios started at lower levels than did Greece's. That said, these countries also need to sharply reduce their fiscal deficits over the next few years. And as with Greece, these countries will find it difficult to stoke GDP growth via exchange rate depreciation. Like Greece, Portugal and Ireland are rather small economies and the IMF could easily extend financing to them as well, should that prove necessary. However, Spain has a €1 trillion economy, making it one of the world's 10 largest economies. Although the probability of an IMF rescue of Spain is low, the sheer size of the Spanish economy means that the IMF would need to cough up a significant amount of money to help Spain. If, in the unlikely event, the IMF needs to come to the simultaneous rescue of the four Euro-zone economies with the worst fiscal situations, the IMF may start to get tapped out.

***There is a significant probability that the IMF will need to come to the Greek's rescue at some point this year.***

## Wells Fargo Securities, LLC Economics Group


| | | | |
|---|---|---|---|
| Diane Schumaker-Krieg | Global Head of Research & Economics | (704) 715-8437<br>(212) 214-5070 | diane.schumaker@wachovia.com |
| John E. Silvia, Ph.D. | Chief Economist | (704) 374-7034 | john.silvia@wachovia.com |
| Mark Vitner | Senior Economist | (704) 383-5635 | mark.vitner@wachovia.com |
| Jay Bryson, Ph.D. | Global Economist | (704) 383-3518 | jay.bryson@wachovia.com |
| Scott Anderson, Ph.D. | Senior Economist | (612) 667-9281 | scott.a.anderson@wellsfargo.com |
| Eugenio Aleman, Ph.D. | Senior Economist | (612) 667-0168 | eugenio.j.aleman@wellsfargo.com |
| Sam Bullard | Economist | (704) 383-7372 | sam.bullard@wachovia.com |
| Anika Khan | Economist | (704) 715-0575 | anika.khan@wachovia.com |
| Azhar Iqbal | Econometrician | (704) 383-6805 | azhar.iqbal@wachovia.com |
| Adam G. York | Economist | (704) 715-9660 | adam.york@wachovia.com |
| Ed Kashmarek | Economist | (612) 667-0479 | ed.kashmarek@wellsfargo.com |
| Tim Quinlan | Economic Analyst | (704) 374-4407 | tim.quinlan@wachovia.com |
| Kim Whelan | Economic Analyst | (704) 715-8457 | kim.whelan@wachovia.com |
| Yasmine Kamaruddin | Economic Analyst | (704) 374-2992 | yasmine.kamaruddin@wachovia.com |




WELLS FARGO SECURITIES