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2010: A Greek Odyssey

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Just when the world was heaving a collective sigh of relief that the 2008 crisis was finally ending, another major crisis has emerged. Late last year, analysts were debating whether we would see a sharp V-shaped recovery from the Great Recession or a more gradual U-shaped recovery. Some prescient analysts spoke of a W-shaped or double-dip path to recovery. They were right but for the wrong reason. The recovery path is indeed facing a double-dip. However, this is not being triggered by the discovery of hitherto hidden toxic assets in the US as had been feared. Instead, it is being driven by the threat of sovereign debt default in Greece.

The global financial system seems remarkably fragile. Greece accounts for less than 2 per cent of the combined GDP of the European Union. Yet, it has set that entire region in turmoil and this in turn has spooked investors across the globe. During the past month stock markets have declined not only in Europe but also in the US and throughout Asia. The decline is now beginning to spill over into commodities like copper and oil.

Greece is in a tight spot. A public debt stock amounting to 115 per cent of GDP is likely to rise to 150 per cent by 2014. This is partly because its large fiscal deficit is adding nearly 14 per cent of GDP to the debt stock annually, and partly because Greek GDP is declining by 4 per cent to 5 per cent per year. Getting back to a sustainable fiscal path will require cutting the fiscal deficit by 10 per cent of GDP by 2014, after allowing for an interest burden amounting to 7.5 per cent of GDP.

Such harsh fiscal compression is not politically feasible. Even the much milder austerity programme announced earlier this month had Greeks rioting in the streets to defend their entitlements and jobs. Nor does Greece have the option to moderate the fiscal compression, combining it with aggregate expenditure switching from imports to exports through devaluation. It is locked into the euro and no longer has its own currency.

Investors are aware of all this. They are also aware of similar debt crises potentially looming in Spain, Portugal, Ireland, Italy and even the UK. Hence, the risk of contagion in case Greece defaults on its debt. It was to stem the fears that European leaders announced a $1 trillion bailout package on May 10, worked out in collaboration with the IMF. This is partly money on the table but mostly guarantees of assistance. Moreover, the 'independent' European Central Bank (ECB) was persuaded to announce that it would buy Greek government bonds three days after its head, Jean-Claude Trichet, announced that the ECB would do no such thing. Initial market reaction was positive. But sentiments turned bearish when investors realised that even this large package would only postpone the date of final reckoning for sovereign Greek debt.

What is the outlook going forward? Three possible scenarios can be envisaged. Greece could withdraw from the EU, revive its own currency and devalue the drachma to stimulate growth and ease the fiscal burden. However, this is quite unlikely since no European country is prepared to see the EU's unravelling at present. Alternatively, Greece can remain in the EU and impose harsh fiscal compression to meet its debt obligations. However, the markets are already discounting this option as being politically infeasible. The third and most likely outcome is that Greece will remain in the EU, and combine politically feasible austerity measures with some debt restructuring, that is, a managed and partial haircut for investors exposed to Greek and derivative debt. The markets are probably factoring in this outcome right now, hence the decline.

How will all this affect India? Finance minister Pranab Mukherjee and RBI governor D Subbarao have both indicated that the impact on India will be limited. They are probably right. Though bigger than the Dubai debt hiccup a few months ago, the Greek debt crisis is nowhere near the scale of the Great Recession that hit the world two years ago. Even then the impact on India was quite muted. Hence, it is reasonable to expect that the fallout of the present crisis will be relatively benign.

Nobody knows how soon the markets will settle. If market volatility is sustained, economic recovery in Europe and other advanced countries will be disrupted. Oil prices will remain soft. There will be an initial capital flight from Europe to the US and other 'safe' advanced country markets. Then fear will give way to a search for better returns, and we should see a significant increase in capital flows to relatively safe emerging markets like India. However, there will be an adverse negative impact on the incipient recovery of India's exports. On balance, a modest negative net impact.

If the markets settle soon, Europe and advanced countries elsewhere will resume their recovery. This will drive up oil prices, but it will also help sustain the recovery of Indian exports. Finally, the settling of markets in Europe notwithstanding, we will probably still see enhanced capital flows to India. On balance, a modest net positive impact.

The writer is emeritus professor, National Institute of Public Finance and Policy, New Delhi.