



P.I.I.G.S. in a Maze of Debt

What happens when a person accumulates huge debts and finds it hard to pay back? Either he depends on his friend to provide a bridge loan or he has to “sell off” his personal valuables to pay off his debt. However, if he “sells off”, he could find himself bankrupt. But if he has a healthy and regular income flow from his job or business he would be able to weather the storm quite easily. Isn't it true that highly paid executives can fund large EMIs pertaining to their home, cars, second home, second car etc. Since they are on high salaried jobs even large EMIs don't seem to bother them. Thus as long as the salary is higher than the EMI, the system works fine.

However once the EMI overtakes the salary, the system starts creaking and only the intervention of a benevolent hand can prevent the system from collapsing.

Some European countries like Greece, Spain, Portugal and Ireland find themselves exactly in this situation. Mounting debts on one hand with pay back time looming

large on the other hand coupled with stagnating economic growth is making it extremely hard to pay their EMIs.

So what options do they have? Either one of their friends extends a helping hand or they observe better fiscal discipline going forward and get more productive. All said and done they do not have too many options left.

In a sense the rescuer of the past is now seeking a lifeline. Earlier the banks defaulted and sovereign government came to their rescue. Now that sovereign debt default is on the anvil, who will come to the rescue?

While the economic recovery has resumed in emerging economies, it would be incorrect to say that “All is well” the world over.

Several European nations are up to their necks in debt and European leaders are burning the mid-night oil to avert euro's biggest financial crisis.

Greece with debt at 112.6% GDP has a high probability to

default at some stage. Despite of low interest rates inside the Euro Greece could do very little to tide over its high deficit situation. If Greece defaults, the contagion would engulf several other countries of Europe. A common currency shared by the Euro Zone has made this everyone's problem. Germany which is best placed as far as fiscal prudence is considered might have to bail out the beleaguered nations. That Greece's debt had been understated by keeping unpaid bills off the books did not help the cause of the already jittery bond investors. The country's credibility has taken such a dive that any kind announcement of restraining program from its government is not able to bring back the confidence.

The reason Greece has got into this trouble is because of its unrelenting borrowing spree on one hand and misrepresentation of its public debt on the other. When the markets realized that the debt situation was grim, the sovereign bonds of Greece came under attack eroding its value. In this context one needs to understand that while the bond sellers sell them cheap the buyers benefit for the additional risk they take by buying the bonds at a lower price and thereby earn a higher yield on their risky investment. The riskier the bond gets the higher becomes the yield an investor gets for the higher risk that he takes. The yields on sovereign bonds of Greece touched 7.1%, the highest since Greece joined the European Union and 4% higher than the bonds of Germany which is considered the safest paper of the Union.

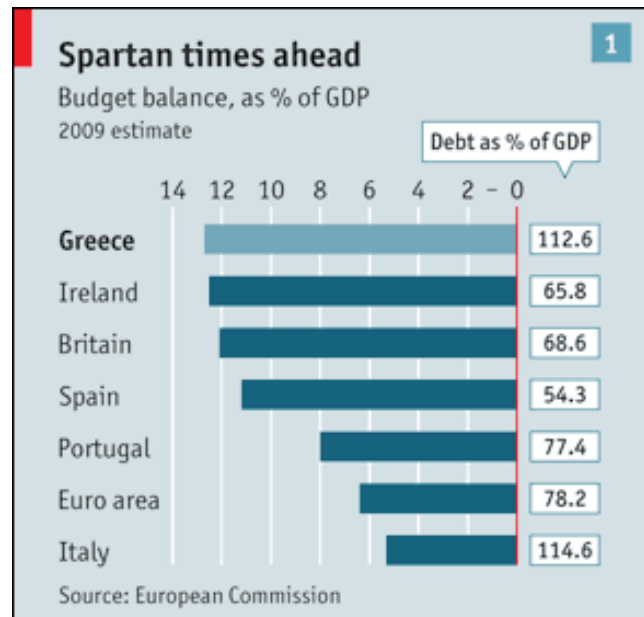
When the markets started offering higher yields for the sovereign bonds of Greece, the government of Greece too had no other option but to offer the higher rates for fresh borrowing. This is how the cost of borrowing for Greece went up and the government could no longer borrow on favorable terms unlike other nations whose finances were in better shape. This is how Greece got pushed into a debt trap.

Since Greece shares a common currency with other European nations, it has been facing pressure from the European Union to take austerity measures such as higher taxes and lower wages to shape up its economy. Greece has one of the most attractive pension schemes which is clearly being funded by such debts. Such schemes will have to be take beating to bring back the much needed balance to the economy.

If Greece goes bankrupt the “euro” will come under threat which will hurt other nations as well. Portugal

which has a high Debt / GDP ratio and a high current account deficit would come under the attack of markets. Italy with a large and liquid bond market is better placed to ride the storm while Ireland with a greater resolve in taking unpopular decisions to set its house in order too is better hedged as compared to Greece.

Thus Greece clearly seems to be the weakest link of the European Union.



The Debt / GDP ratio of Greece is 112.6%. It has been seen that when Debt / GDP ratio crosses 60%, the impact of any government spending does not yield desired results. Large debt leads to questions about the economy's ability to sustain the same. It leads to higher fiscal deficit that gets

counterbalanced by more borrowing and a consequent hike in interest rates. A higher interest rate regime adversely impacts the profitability and growth rates of companies leading to sluggish growth in the incomes. Unemployment rates go up and consumption rate consequently nose dives adversely affecting profitability of companies even further and setting up a vicious downwards spiral for the economy. The only option left for such economies is to enhance the productivity of their economy. Productivity, interestingly can be controlled by either

1. Increasing the output or
2. Decreasing the input.

While the first option is almost ruled out for a debt ridden economy the only option left is of reduction of inputs. This is more often than not achieved by introducing serious and unpopular reforms and austerity measures..

Investors also worry about Spain. At 19.5% it has the highest unemployment rate in Europe. This coupled with an economy still in recession does not bode well for the near term. A fiscal deficit of 11.4% adds to the nervousness of investors. Forced spending on the unemployed and tax cuts have driven Spain into a corner and unless economy is rekindled on to a growth trajectory its debt is bound to come to haunt it.

Unpleasant news on sovereign debt emanating from Greece, Spain, Portugal and Ireland has sent a shiver down the spine of Europe. Bond markets too have become nervous as these countries would have to raise interest rates and curb spending despite being mired in recession.

It is evident that debt laden sluggish European economies would find it hard to overcome the hurdles to attain economic growth.

In this context it has to be borne in mind that economic recovery would be closely related to the scale of the sovereign-debt problems. Whether Greece alone has to bite the bullet or whether other nations to be going to be dragged into the debt trap would have a significant bearing on the economic recovery in Europe. If investors begin to lose confidence in other heavily indebted governments, it will become hard to prevent the contagion from spreading.

The crux of the PIIGS problem is to do with the fact that these countries have raised large debts in euro on the back of low borrowing costs. Now on the eve of repayment, they do not appear prepared to unload their debt. Since the euro is a common currency for the entire zone, any default on payments runs the risk of weakening the currency and thereby dragging several other nations into the crisis for no fault of their own.

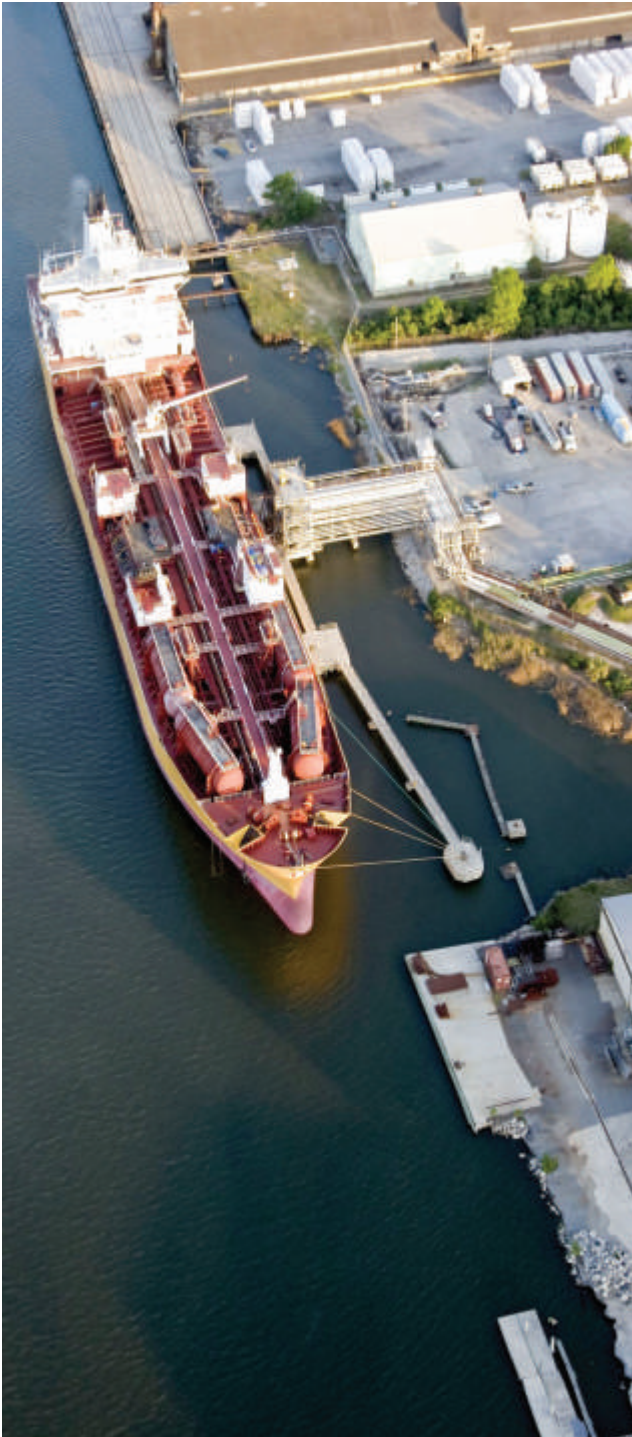
The only option left for those directly affected is to implement tough austerity measures and subjecting their economies to painful recessions. Otherwise they can quit the euro and introduce a new currency. Either way, the outlook is grim for these countries.

One needs to draw the right lessons out of the anguish experienced by Greece, Spain and Portugal and instead of a knee jerk reaction resulting in the withdrawal of fiscal stimulus one needs to bear in mind that not all deficits today are dangerous. Where governments need to show resolve is in framing growth oriented policies and curb spending so that the fiscal deficit does not go out of control. Thus, the way forward hinges on the abilities to foster productivity and exhibit parsimony.

The Way Forward

Whatever needs to be done to stem this rot has to be in the





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form of a coordinated action of ECB along with other European countries.

A bail out would lead to printing of more money which would hurt the value of the euro. Hence the bond markets should work on the same principles with which they lend to corporations. The endeavor should be to restructure the debt as the current burden is too large as compared to the euro-area limit of 3% of GDP. Portugal's 2009 budget deficit was 9.3%; Ireland's was 11.7%; and Spain's was 11.4%. Getting these countries to make a drastic cut in their spending would push them deeper in recession. Tax revenue which is a function of economic transactions spurred by healthy demand would get undermined making it even more difficult to meet the debt obligations. If the bond holders operate under the same principle as they normally do with corporations they would have to share this pain as well. So rather than fall into the bailout trap, it would augur well for the ECB to mediate some sort of debt restructuring for the PIIGS nations. A temporary suspension of interest payments or an offer to make 50% debt payments could be part of this restructuring. This is what would have happened if a company was struggling to pay back its debts. If done in a controlled manner, the situation could be prevented from getting out of control. The ECB, in order to provide bridge loans to PIIGS, must exact emergency economic reforms from these nations which would have otherwise been impossible by the elected politicians pandering to popular sentiments. These could take the shape of cutting state spending and taxes to re-kindle economic growth. The writing on the wall is clear – trading off short term pain for long term gain.

The time is also ripe to define the obligations of the different countries united by a common currency. The euro cannot flourish if member countries accumulate huge debts and expect other countries of the Union to bail them. A decision on the regulatory powers of the ECB would need to be re-visited and suitable policies framed in order to bring strength and stability to the euro.

■ Dharmendra Satapathy