Greek debt crisis fuels fears of European sovereign default

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Figures released this month on some of Europe's weakest economies, including Greece, Ireland and Spain, point to the threat of a second continent-wide recession.

New figures from the Greek statistics agency show that the country's recession deepened in the second quarter. This was the seventh successive quarter registering a decline in economic growth. Growth fell by 1.8 percent, compared to the first three months of the year. This was worse than the 1.5 percent forecast in official estimates. In the first quarter of the year, gross domestic product (GDP) contracted 0.8 percent. Over the second quarter, public consumption declined 8.4 percent and private consumption by 4.2 percent. Over the past year, GDP has fallen by 3.7 percent.

Tax increases on fuel, alcohol and tobacco have helped drive the inflation rate to a 13-year high of 5.5 percent.

Unemployment year-on-year to June rose by 3 percent to 11.6 percent, according to official figures. Among 15-to-24-year-olds, the rate is significantly higher, at 32.5 percent. This is even before hundreds of thousands of public sector workers set to lose their jobs join the dole queues.

Elected last October, the Greek social democratic PASOK party government is imposing a €30 billion austerity programme in return for a €110 billion bail-out package agreed in May with the European Union and International Monetary Fund.

Contrary to the claim that the worst of the economic crisis is over as a result of the bailout, leading economists have warned that Greece will be unable to pay back its mountain of debt, with some forecasting that it will ultimately be forced to abandon the euro currency.

Speaking to the European House Ambrosetti forum at Lake Como earlier this month, German economist Hans-Werner Sinn, head of the IFO Institute in Munich, said, "This tragedy does not have a solution."

Greece would have defaulted in the period between April 28 and May 7 had the money not been promised by the EU, he said:

"Greece would have been bankrupt without the rescue measures. All the alternatives are terrible but the least terrible is for the country to get out of the eurozone, even if this kills the Greek banks."

Sinn warned, "We are in the second Greek crisis right now, today. The policy of forced 'internal devaluation', deflation, and depression could risk driving Greece to the edge of a civil war. It is impossible to cut wages and prices by 30 percent without major riots".

Critical to establishing the €110 billion bailout was the fear among European governments that a default by Greece on its debt obligations might result in financial "contagion" in other countries, such as Portugal and Spain. Crucially, the money lent to Greece would go back to pay the banks, particular those in France, Germany and the UK, which collectively hold 80 percent of Greek sovereign debt. The UK is not part of the eurozone, but UK-based banks have lent money to Greece.

A report issued in July by the Washington-based Centre for Economic and Policy Research explained this fundamental aim of the bailout plan:

"Europe and the IMF are not so much providing Greece with fresh finance but, most of all, shielding the European financial system from up to 200 billion euros of losses that could result from a Greek default. Curiously, almost one quarter of Greek debt is located in the UK (and Irish) financial sector. The obvious beneficiaries of the Euro Area governments' package are not Greek workers and citizens, who will suffer from severe budget cuts and recession, but financial centres such as the City of London."

The Greek government hoped that the bailout would safeguard the economy against further pressure from global capital markets. Within the space of a few months, this strategy has already failed. The markets have continued to speculate that Greece will default on its debt and "spreads" on longer-term Greek government debt have continued to lengthen. Ambrose Evans-Pritchard warned in the *Daily Telegraph* September 3, "Spreads on longer-term Greek government debt have surged back to crisis levels of about 800 basis points, implying a high risk of default."

Further speculation against Greece and its banks took place last week following the announcement by the National Bank of Greece (NBG), the country's top lender, that it needed to raise €2.8 billion (£2.3 billion) in fresh capital. The NBG is planning to raise the funds with a share issue and by selling part of its holding in Turkish subsidiary Finansbank.

The NBG, as with other Greek banks, has had no access to interbank market lending and relies on European Central Bank funding. The move by the NBG to raise several billion euros in capital was endorsed by the government, which hailed it as a sign that the Greek banks were freeing themselves from overall dependency on the European Central Bank.

The Greek state is the largest single shareholder in NBG. Finance Minister George Papaconstantinou said the move "shows the trust of international investors in the Greek banking system and the wider local economy".

The fact that the money markets thought otherwise was soon apparent, as shares in the NBG dropped as much as 12 percent.

The NBG was one of five Greek lenders to pass the European-wide stress tests in July. The tests were not designed to give an accurate account of the perilous state of European banking, but were merely a confidence-building exercise dictated by the banks themselves. Their purpose was to attempt to reassure the jittery money markets and stabilise the euro.

Summing up the decision of the bank to seek further liquidity, Nick Skrekas of the *Wall Street Journal* commented, "Even if NBG comfortably passed the European Union stress test in July, a deepening Greek recession has lead to spiralling provisions for bad loans, prompting the need for additional capital.

"In conjunction with trading losses on its Greek government bond portfolio, given rating agency downgrades and a sell-off on the local bond market, meant that second-quarter net profit fell 68 percent year-on-year."

Speculation against government bonds in a number of other indebted countries has continued apace. Last week, investors drove up the price of financial insurance against an Irish government-bond default. Yields on Irish 10-year bonds rose above 6 percent for the first time since the launch of the euro.

In an attempt to stem the frenzied speculation, the Irish government announced that it would divide the state-owned Anglo Irish Bank Corp into two parts—one based on customer deposits and another "asset recovery bank", which would hold its bad loans.

US business and economics analyst, Megan McArdle, commented on the decision, "It's not a good sign when the government has to intervene to prevent a run on a bank that is already owned by the government, but apparently, that's what it's doing with Anglo-Irish bank".

Commenting in the *Irish Times*, Fintan O'Toole, wrote in apocalyptic tones, "The choice is now stark: do we go on being 'good Europeans' at the cost of destroying our own society or do we become 'bad Europeans', lose the trust of our European partners, but save ourselves?"

"There comes a point of existential crisis when even the meekest of countries has to put its vital national interests (first). We are at that point now."

In a September 8 *Daily Telegraph* column on the sovereign debt crisis, Evans-Pritchard drew attention to the crisis in Ireland and stressed that this was a critical European-wide problem. "Credit default swaps (CDS) for Portugal, Spain, Italy, and Belgium have all surged this week," he noted. According to Markit, the international financial information services company, the "stress gauge for the [eurozone] group is now higher than during the debt crisis, when the EU launched its €440 billion bail-out fund and the European Central Bank began buying eurozone bonds."

The article cited the comments of Joachim Fels, the chief global economist at Morgan Stanley, who concluded that "one or several governments" may soon have to resort to the rescue mechanism. Fels warned that the stress testing of the European banks had failed to instil any lasting confidence, and concluded, "Neither the European sovereign debt crisis nor the banking sector crisis has been resolved, and both continue to mutually reinforce each other".

The International Monetary Fund has sought to play down the risk of a nation defaulting on its debt. The IMF said in a September 1 report that "current market indicators of default risk seem to reflect some market overreaction".

This evaluation was in contradiction to the results of an IMF study that detailed governmental debt sustainability internationally. The study researchers concluded that many countries are now running unsustainable levels of debt and have virtually no "fiscal space". Fiscal space was defined by the IMF as the difference between the current level of public debt and a debt limit implied by each country's own record of fiscal adjustment. The fiscal space indices essentially measure how much scope a nation has to borrow from financial institutions before the markets shuts off the supply of funds by demanding unsustainable interest rates.

"In particular, Greece, Italy, Japan, and Portugal appear to have the least fiscal space, with Iceland, Ireland, Spain, the United Kingdom, and the United States also constrained in their degree of fiscal manoeuvre" the study said.

The risk of Greece or another indebted European nation defaulting on its debt looks increasingly likely, as the CDS traders at major banks and hedge funds target them to take advantage like vultures to a decaying corpse.

Even if Greece meets all the obligations of its austerity programme, the IMF has calculated that it will have a rising sovereign debt ratio of 145 percent of GDP by 2014. This compares to a ratio of 115 percent in 2009.