Debt Crisis in Greece Calls for Better Financial Oversight

The beginning of 2010 witnessed the onset of a financial crisis in the European Union (EU), threatening the financial stability of its members. In particular, the fear of debt crisis and the possibility of loan defaults in Greece, Portugal, and Spain led to a loss of confidence among investors, making it hard for these countries to borrow funds and to pay interest on national debt. Greece was the worst-hit country, where a large spiraling federal deficit and a large national debt in 2009 caused major lending institutions to downgrade Greece’s international credit rating. In order to save Greece from defaulting on its national debt and prevent the financial crisis from spreading to other countries with weak finances, the EU and the IMF had to take unprecedented steps to restore financial stability.

Initially, the dire situation of the Greek economy was hard to accept because the country had experienced robust economic growth. Between 2002 and 2007, the economy grew 4.2 percent per year, which was higher than the average in the euro-zone. Large capital inflows, falling bond yields, and strong economic growth allowed the government to run large structural deficits at an average of 5.1 percent of the country’s Gross Domestic Product (GDP). Still, Greece was heavily indebted with a Debt-GDP ratio of 123.1 percent. Greece’s economic performance during this period was in violation of the Stability and Growth Pact agreement that members of the Economic and Monetary Union had agreed to follow. It stipulated that a member’s annual budget deficit to be no higher than 3 percent of the GDP and that national debt should not exceed 60 percent of the GDP. In 2008-2009, economic conditions turned for worse with zero growth, double-digit Deficit-GDP ratio, and triple-digit Debt-GDP ratio.

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<tr>
<td>GDP Growth (annual %)</td>
<td>3.4</td>
<td>5.6</td>
<td>5.0</td>
<td>2.2</td>
<td>4.5</td>
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<td>Inflation Rate (%)</td>
<td>3.6</td>
<td>3.5</td>
<td>2.9</td>
<td>3.5</td>
<td>2.2</td>
<td>2.9</td>
<td>4.2</td>
<td>1.2</td>
<td>3.1</td>
<td>2.7</td>
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<tr>
<td>Budget Deficit (% of GDP)</td>
<td>-4.8</td>
<td>-5.8</td>
<td>-7.3</td>
<td>-5.3</td>
<td>-3.1</td>
<td>-4.0</td>
<td>-7.8</td>
<td>-13.6</td>
<td>-5.1</td>
<td>-10.7</td>
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<tr>
<td>National Debt (% of GDP)</td>
<td>127.4</td>
<td>123.6</td>
<td>126.3</td>
<td>126.9</td>
<td>119.6</td>
<td>115.0</td>
<td>114.8</td>
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The Stability and Growth Pact proved to be controversial because it lessened the fiscal authority of individual governments in the euro-zone to regulate their economies. In order to raise funds without blatantly violating the Stability and Growth Pact, Greece engaged in accounting practices that hid from investors and regulators the huge deficits that the
government was running in order to pay for its expanding bills. Banks offered Greece money through sophisticated financial instruments such as credit default swaps and derivatives that left increasing liabilities off the books. For instance, in 2001 the Greek government paid Goldman Sachs around $300 billion in fees to hide billions of dollars in loans. The deal was made in such a way that it appeared to be a currency swap between this renowned investment ban006B and Greece instead of a loan. There were other deals that the Greek government made with foreign banks using derivatives that used off-balance sheet accounting in order to hide debt.

Nevertheless, the deception had to come to an end sometime. When the global financial crisis started in 2008, the Greek economy suffered severely because two of its largest sectors, tourism and shipping, are particularly vulnerable to economic slowdowns. In October 2009, the newly elected Greek government announced that the budget deficit for that year was headed toward 12.5 percent of GDP, which was more than three times of the previous estimates. Investors quickly panicked and started dumping Greek government bonds. Facing huge debt repayments in spring 2010, it became increasingly clear that Greece would not be able to borrow the amounts that had to be paid.

As its financial conditions rapidly deteriorated, many investors began to fear that Greece might default on its loans. Furthermore, Portugal, Spain, Ireland, and Italy had also accumulated large national debts, and investors began to fear that these countries might follow the path of Greece in the near future. When the financial crisis of Greece began to spread to other nations, some investors began to question whether the euro might eventually collapse, putting an end to the EU. In a quick and drastic response, members of the euro-zone initiated a bailout plan for the Greek government in order to reverse investors’ panic, which was threatening the future of the union.

The response to the national debt crisis came on May 2, 2010, when the euro-zone members and the IMF agreed to a three-year loan package to Greece worth €110 billion. Moreover, in order to prevent the crisis from spreading to other euro-zone members, the European Stabilization Fund was created on May 9, 2010 consisting of €500 billion from euro-zone members and €250 billion from the IMF. Greece was required to cut its national spending in order to repay its debt and restructure its economy. Many were surprised that the IMF was a key player in the bailout because prior to the Greek financial crisis, the IMF only loaned to poor ex-communist countries in Europe, but had never been involved in the financial affairs of a developed euro-zone member.
Unfortunately, the bailout of Greece has not reassured investors about the possibility of robust Greek recovery. The country is considered economically uncompetitive. Even with a huge loan package, there are doubts in the investment community whether Greece will be able to repay its loans, making it harder for the government to obtain loans. The long-term interest rate for 10-year government bonds jumped from an average of 9.1 percent in June to 9.57 percent in October. National debt is projected to reach 131 percent of the GDP by the end of 2010 and the budget deficit is estimated at 8.1 percent of the GDP. The majority of the Greek population is opposed to the budget cuts required by the IMF and the euro-zone members, with national strikes disrupting economic activity. Such national reactions have created doubts among international investors and institutions that the Greek government will be able to deliver on the tough conditions required to restructure its economy when the vast majority of the population does not support its policies.

The onset of the Greek sovereign debt crisis this year has raised many important questions about the rules governing economic relations within the euro-zone. There are two main issues that stand out. First, despite having a single currency and central bank, national economic policies are not coordinated. Second, even though the euro-zone members have signed the Stability and Growth Pact governing the maximum budget deficit a country can run and the maximum amount it can borrow, there is no real central authority to enforce these rules. There are calls now to strengthen the power of the European Commission so it can enforce effectively the Stability and Growth Pact and apply stringent sanctions on violators. However, it is unlikely that this can happen because most governments would see the stringent application of the Stability and Growth Pact as a threat to their sovereignty. And even if this binding agreement were enforced, it could cause detrimental effects because it would hamper the ability of euro-zone governments to run deficits in order to stimulate their economies during recessions.

One extremely important issue about the Greek sovereign debt crisis as well as the financial crises in the past three decades has still not been addressed. According to the concept of moral hazard, when financial firms believe they will not carry the full burden of making unsound loans, they will make such loans because if they become non-performing, a government or an international institution will bail them out. In the case of Greece, the bankers that helped Greece disguise the extent of its budget deficits have not been punished. This is despite the fact that they colluded with the Greek government and almost contributed to the collapse of the European currency. However, the Greek government and especially the people of Greece will carry the full burden of the financial mess that some international banks helped to create.

The Growth and Stability Pact requires transparency and effective regulations so that governments in the euro-zone will not hide their deficits and debts with unregulated
derivatives like Greece. However, current regulations do not require such derivatives to be disclosed on the balance sheets of governments, making it harder to know the extent of loans that euro-zone member owe. The crisis in Greece shows that disclosing such transactions must be mandatory. Therefore, new financial regulations must be passed within the euro-zone in order to increase the transparency of the financial system and prevent such crises in the future.

References
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www.ecb.int/stats/money/long/html/index.en.html