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Scale of Greek default would be unprecedented

Failure would be five times bigger than Argentina's

By Dave Simms, CBC News Posted: Sep 29, 2011 11:37 AM ET | Last Updated: Sep 29, 2011 11:53 AM ET 66

Protesters hold a giant flag outside the Greek parliament in Athens on Tuesday during an anti-austerity protest. A default could send shock waves through financial markets in Europe and the world. (Petros Giannakouris/Associated Press)

If Greece defaults, it won't be the first government to renege on its financial obligations, but its failure would set a new record, both for scale and complexity.

At the moment, the dubious honour of biggest deadbeat goes to Argentina, which failed to make good on its government debts in December 2001, to the tune of about $100 billion US.

For some economists, a Greek default is just a matter of time.

“It's inevitable,” Thorsten Koeppl, a Queen's University economics professor told CBC News. “Eventually a default will happen.”

Martin Schwerdtfeger, a TD Bank senior economist, agreed.

“I actually believe they will end up defaulting, and it could happen anytime” Schwerdtfeger said.

Even if there is a second bailout of €8 billion ($11 billion Cdn) from the International Monetary Fund, the European Central Bank and the European Commission to gain some time, he predicted, by the New Year “things will get very difficult.”

Greek banking system 'will be mostly wiped out'

Greece is on the hook for almost five times as much as Argentina was, and the question of a how a Greek default might unfold — and how far afield its effects might spread — is a massively more complex question.

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Argentina had a currency board, which tied the convertibility of one peso to one U.S. dollar.

Greece is one of 17 countries that share the euro in a currency union.

"The difference between the two revolves around commitment; a currency union is like a marriage, whereas a currency board is like a couple that's going steady," ATB Financial analyst Will Van't Veld said in a recent commentary.

When Argentina went into a recession at the end of the 1990s and exports fell, its central bank lost the access to the vast amounts of foreign reserves required to support the peso, and default followed.

Eventually, the Argentine government negotiated a settlement with 70 per cent of its private debtors, paying 30 cents on the dollar.

Argentina's default was followed by economic collapse.

Workers demonstrated against austerity measures in downtown Buenos Aires, Argentina, in December 2001. Unemployment hit more than 19 per cent after the government defaulted. Daniel Luna/Associated Press

Unemployment hit more than 19 per cent and inflation soared. The number of Argentines below the poverty line doubled and the government's austerity measures were met by violent protests.

Eventually its economy picked up strongly, but only thanks to a fortuitous upswing in commodities prices and its ability to benefit from those increases with its devalued currency.

But it still suffers from high inflation, and it has taken nine years for the Argentine government to even begin to establish the creditworthiness, which promises to open up access to capital markets.

Greece is far more complicated, given the extent of exposure by banks and insurance companies elsewhere in the euro zone to its debt.

That debt was once considered low risk, given Greece's status as a sovereign member backed presumably by the good credit of the entire currency union.

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Big, fat Greek sell-off

But with its massive debt, its borrowing costs have soared.

The government has been forced to seek help from the European Commission and the International Monetary Fund and, as a condition, has agreed to impose spending cuts that have led to public demonstrations and protests.

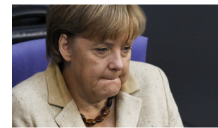
Argentina was on the mind of Greek Finance Minister Evangelos Venizelos on September 22, when he warned that if government spending cuts make things look bad to Greeks now, it could become much worse.

"People, justifiably, think the crisis is what we're living now: cuts in wages, pensions and incomes, fewer prospects for the young," Venizelos told reporters in Athens.

"Unfortunately this isn't the crisis. This is an attempt, a difficult attempt, to protect ourselves and avert a crisis. Because the crisis is Argentina: the complete collapse of the economy, institutions, the social fabric and the productive base of the country."

For Schwerdtfeger, austerity taken too far is a missed opportunity to learn from the past.

"The first lesson we should have learned from the Argentina experience was that once you put in place extremely harsh fiscal tightening programs, they tend not to work because they induce a severe deceleration in economic activity, and that is what is playing out in Greece right now."



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Predicting effects difficult

Anticipating the effects of a Greek default elsewhere is difficult, said Schwerdtfeger, because contagion "could take so many forms and the ramifications of this at some point are unpredictable."

A controlled Greek default — where the governments and central banks of the leading economies move quickly and convincingly to shore up the Greek administration and its domestic banks — could keep losses manageable.

At the other extreme, a messy collapse could mean domestic banks take enormous losses on the Greek government bonds held on their balance sheets, losing the collateral needed to borrow from the European Central Bank.

And if Argentina is a guide, the banking system in Greece "will be mostly wiped out," after a default, Schwerdtfeger predicted.

Greece would need to nationalize its banks, something that can only be achieved after leaving the euro zone and recapitalizing its banks using its own currency, one much devalued against the euro, Schwerdtfeger suggested.

U.S. Treasury Secretary Timothy Geithner, speaking on September 24 made clear what he thought a disorderly Greek bankruptcy would mean.

"The threat of cascading default, bank runs, and catastrophic risk must be taken off the table, as otherwise it will undermine all other efforts, both within Europe and globally."

One thing's certain: all European financial institutions exposed to Greek debt — especially French and German banks —would be required by regulators to write down the value of those loans, weakening their balance sheets.

> 'One could say that the risks would be very high for a recession in Europe.'
>
> —Thorsten Koeppl, economics professor, Queen's University

Koeppl, who is originally from Germany and spent two years working as a researcher at the European Central Bank before coming to Queen's in 2004, said if Greece defaults, that might further rattle nervous bond markets, leading borrowing rates to soar and increasing the probability of default by that other debt-constrained European countries such as Portugal, Ireland, Italy and Spain.

And it's possible there would be consequences for the real economy.

A Greek failure might undermine confidence across the region, causing businesses to delay investment in growth and consumers to curtail spending.

"One could say that the risks would be very high for a recession in Europe," Koeppl suggested.

If a Greek default is inevitable, Koeppl said, it's time to draw a line in the sand.

Rather than spending billions to delay what may already be a certainty, better to use those billions to shore up banks exposed not only to Greece but also to other weakened economies, as they write down their loans.

"It might be more effective to bail out the banks than Greece itself and basically say, 'Well, let Greece default, and we deal with the fallout,'" said Koeppl.

Closer fiscal harmonization predicted

And in the long term, he predicted, the governments of the European Union will likely have to more closely bind themselves to common policies on taxation and spending, and sign on to strict enforcement standards.

"It's more about putting the euro area and the European Union on a

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sound fiscal footing."

Governments that become reckless spenders in future would face a bailout and intervention by the International Monetary Fund, which would "come in and take over some of the fiscal authority of the countries being bailed out and basically prescribe a particular policy package that would establish fiscal austerity and fiscal discipline measures on these countries," he said.

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