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The Greece Turmoil and its Possible Implications on the Philippine Economy

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Greece stunned markets in October 2009 when it revealed that its budget deficit for 2009 would be several times higher than the 3 percent ceiling imposed by the EU, with total borrowing need for 2010 estimated at EUR53.2 billion (US$65.80 billion)[2] or 21.8 percent of GDP. In April 2010, it was announced that Greece's 2009 budget deficit was 13.6 percent of GDP, higher than the 12.7 percent reported earlier.

In its stability programme, the Greek government confirmed plans to cut the public deficit to GDP in 2010 by 5.5 percent[3]. By 2012 the deficit ratio is to be slashed to 2.8 percent, below the Maastricht limit of 3 percent. Greece cannot finance its fiscal deficit through money creation process because, being a member of the Euro block, it does not have an independent monetary policy.

Given this constraint, Greece could implement revenue-enhancing and expenditure-rationalizing measures, as well as undertake debt issuances. On 9 February 2010, Greece unveiled a set of tax and wage reforms aimed at increasing state revenues and reducing its deficit. Tax reform measures include raising tax for high income earners (e.g., lowering the threshold of the application of the upper 40 percent tax rate to earners of EUR60,000 from EUR75,000) while reducing the tax burden of low income earners (reducing income tax of those earning between EUR12,000 and EUR16,000 to 18 percent from 24 percent). Public sector employees, meanwhile, will experience a freeze on their wage rates, as well as a reduction in their benefits. The private sector holds separate negotiations with employees, but the state sector policy is often used as a guide for collective wage agreements.

Additional austerity measures – half of which via revenue increase, while the other half via spending cuts – were announced by the Greek government in March 2010. These measures were estimated to reduce further the 2010 budget deficit by EUR4.8 billion (2 percent of GDP).[4] The revenue-enhancing measures include the following:

- Increase in VAT by 2 percentage points to 21 percent, which is expected to generate an additional revenue of EUR1.3 billion or 0.5 percent of GDP;

- Increase in excise taxes on gasoline, cigarettes, electricity and luxury goods, which could boost revenues by EUR1.1 billion (gasoline, EUR450 million; cigarettes, EUR300 million; electricity, EUR250 million; and luxury goods, EUR100 million); and

- One-off tax on big property holdings that is expected to generate an additional EUR200 million in revenues. Greece will also impose a one-off tax of 1 percent on those who earned over EUR100,000 in 2009 and will devise ways to levy taxes on church properties and income.

The expenditure cuts consist of the following:

- Further cuts in the government's wage bill, which may result in overall savings of about EUR1.7 billion. This amount includes EUR740 million in savings from a 30 percent reduction in salary bonuses for Easter and Christmas vacation periods

[1] Bank Officer V, Department of Economic Research
[2] Using an exchange rate of EUR1/USD1.2369 as of 25 June 2010
[3] Commerzbank, 17 June 2010
[4] Reuters, 4 March 2010

and a 2 percent additional cut in supplementary allowances;

- EUR360 million in cuts from a 7 percent bonus and pay reductions in utility salaries, EUR150 million from cuts in subsidies to pension funds, and EUR450 million from a freeze on state pensions;

- Spending cuts in the government's public investment and education programmes, which are expected to result in additional savings of EUR700 million; and

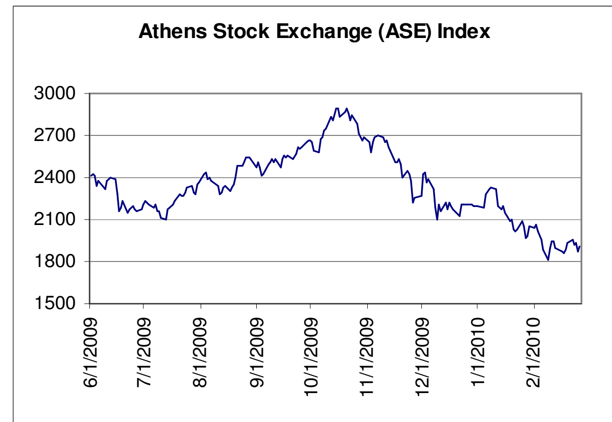
- Reduction in public sector supplements of 12 percent (compared to 10 percent announced previously). Sate sector overtime pay will also be cut by 30 percent.

It was estimated that the overall austerity programme announced by Greece may sum up to around EUR12 billion (US$16.4 billion). It may be noted, however, that gaining popular support for these austerity measures may be difficult to achieve, particularly during these trying times in Greece. Menelaos Givalos, a professor of political science at Athens University, warned about the "extreme social consequences" of an impending wave of layoffs in Greece starting in September.[5]

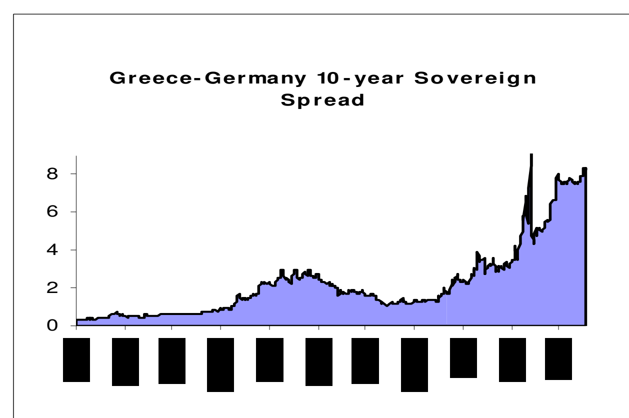
On the external front, even if the current account deficit of Greece shrank by 23.3 percent in 2009, it remained at 10.8 percent of GDP. Credit Agricole expects Greece's current-account deficit to average 9.5 percent of GDP in 2010, and 7.8 percent in 2011.[6] This is also a constraint that will contribute to Greece's needs for external financing.

The above fiscal deficit problem, aggravated by persistent current account deficits, has increased Greece's cost of borrowing. On 14 June 2010, Greece's credit rating was lowered by four steps to Ba1 from A3 by Moody's, which cited "substantial" risks to economic growth. This caused skepticism about the ability of the country to honor its obligations, which prompted investors to pare down their exposures to Greece.

- The Athens Stock Exchange (ASE) general index is on the declining trend. From a six-month high of 2,896.91 points registered on 14 October 2009, the ASE index plummeted to a low of 1,403.92 points on 7 June 2010.

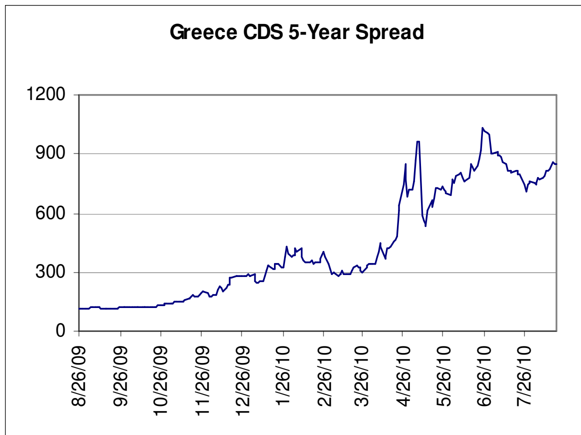


- The spread between the Greek and the German 10-year sovereign debt soared to 965 basis points (bps) on 7 May 2010, significantly higher than the spread of 32 bps recorded at the beginning of 2008. As Greece's ability to repay its debt is put into question, it has to sell its debt at ever steeper yields. This adds further strain to the budget and could impinge on potential recovery effort, with banks charging higher interest rates on loans to households and businesses.



- The cost of insuring debts issued by Greece against default, via credit default swap (CDS), rose nine-fold from a low of 101 bps on 4 August 2009 to a high of 1,037 bps on 24 June 2010.

[5]http://www.spiegel.de/international/europe/0,1518,712511,00.html
[6] Credit Agricole Forecast, August 2010

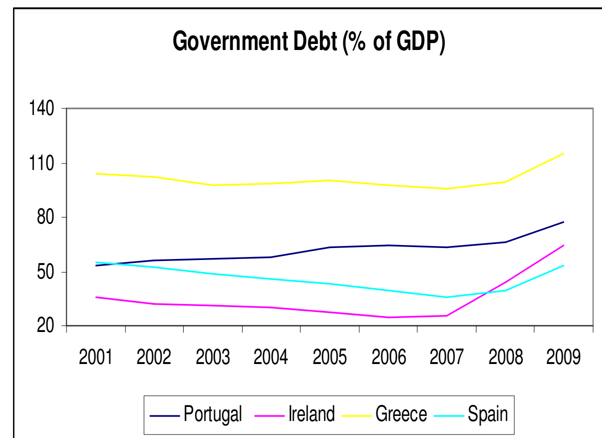


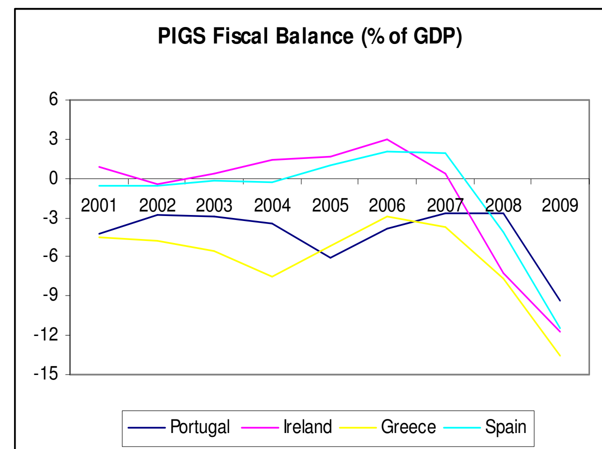
Aside from Greece, who are the other European nations facing debt burdens that could potentially lead to similar debt crisis experienced in Greece?

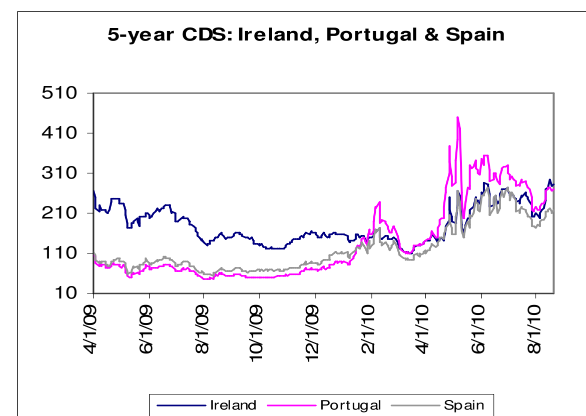
There were also concerns that the Greece turmoil could spread to other Eurozone countries beset by fiscal constraints, albeit smaller in scale compared to Greece's. Portugal's government debt reached 77 percent of GDP in 2009, with short-term debts threatening to cause cash flow problems for the country. Portugal needs to raise EUR37 billion (US$50.4 billion) or 23 percent of its GDP this year. Ireland's debt-to-GDP ratio jumped to 64 percent in 2009 from 25 percent in 2007. Rising debt in Spain also poses considerable risks for the Eurozone. Spain's debt-to-GDP ratio is estimated to reach 66 percent in 2010 and peak at 82 percent in 2014, from a debt-to-GDP ratio of 36.1 percent in 2007. Although financial institutions operating in Spain had practically minimal exposure to toxic securities that underpinned the global financial crisis, they are exposed to the highly leveraged domestic real estate sector.[7]

Similarly, the costs of borrowing of these countries have also risen and remained elevated.

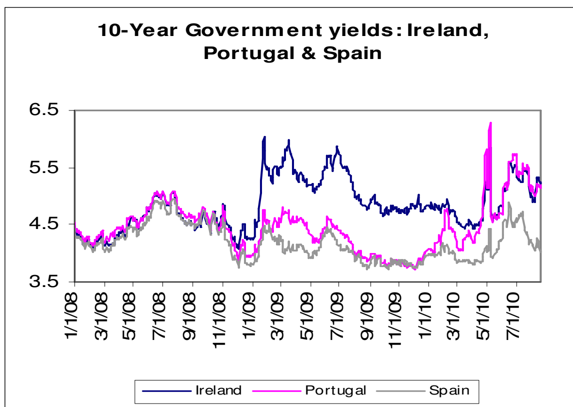
- The euro generally also weakened against major currencies and against the US dollar. The euro reached a low of EUR1.1877/USD1 on 7 June 2010. This was the lowest level since March 2006. Recently, the euro recovered some lost ground as concerns about the possibility of the US economy succumbing to a double-dip recession emerged. However, the gains were still much lower compared to levels before the deepening of the Greek turmoil during the middle of the year. The euro is currently trading in levels similar to the US dollar as recorded in the last week of April 2010.

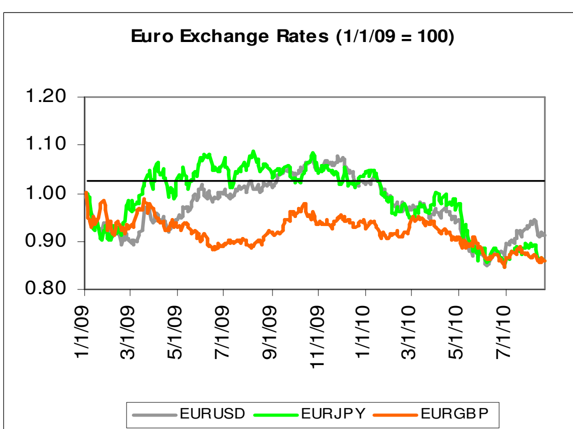






[7] Credit Suisse, 5 February 2010





What are the financial assistance extended to Greece and other European countries to address their fiscal debt problems?

Greece was able to secure a EUR110 billion financing package from the IMF, the European Commission and the European Central Bank (ECB), aside from implementing austerity measures designed to enhance revenue and rationalize expenditures.

To counter concerns that the fiscal woes of Greece was spreading across other European countries, the European Union implemented a EUR750 billion financial package – on top of the EUR110 billion financial support for Greece – designed as a safety net for other peripheral countries at risk. The major elements of the safety net are:

- EUR60 billion stabilization fund from the EU Commission;
- EUR440 billion in loan guarantees from Euro member states; and
- EUR220-250 billion top-up envisaged from the IMF[8]

One fundamental issue about bailing out organizations, whether corporations or countries, is the moral hazard associated with it. This could be mitigated by imposing tougher conditions to deter any potential repeat performance. Another issue at stake is the belief that the bail-out money could become unlimited since the European Union would have no other recourse but to increase the bail-out fund if the current allocation – so far amounting to a total of EUR860 billion – is not enough. Not doing so will only make the EUR860 billion go to waste.

What are the Possible Effects of the Greece Problems in the Philippines?

Contagion and Market Risks

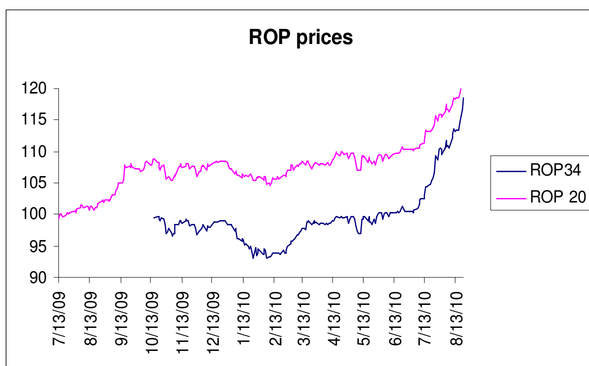
The problems besetting Greece serves as a tough reminder of the fragility of the ongoing global economic recovery from the recent financial turmoil. Like the recent financial stress in Dubai, the Greece financial turmoil can be viewed as an "aftershock," which at best can only create short-term noise with little effects on other emerging countries, particularly the Philippines. It could also be considered as an event that would usher in renewed fears among investors to warrant heightened risk aversion that could put a halt to the recent headways in global economic activities.

The Philippines is potentially exposed to the Greece problem via the contagion risk. The Philippines, along with emerging market economies, could be severely affected by risk aversion that may arise if the Greece financial stress deepen and spins out of control. A major jolt in confidence among investors may prompt them to seek refuge in assets perceived as safe haven such as the US dollar and US government debts. The contagion risk can translate into market risk where as a result of flight-to-safety, investors may simultaneously dump and sell emerging

[8] Bank of America Merrill Lynch, 10 May 2010

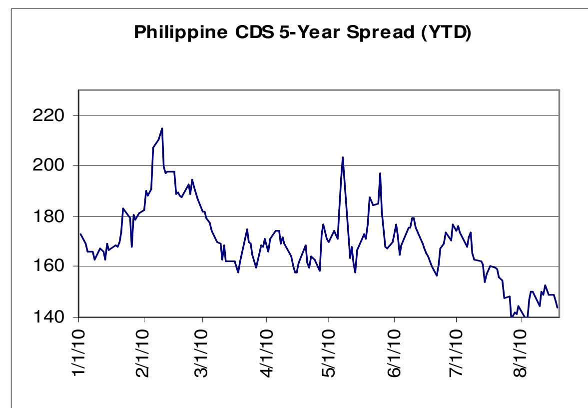
market assets (which are deemed riskier), including assets from the Philippines. In addition, concerns about Greece's inability to service its sovereign papers may lead as well to collective selling of sovereign papers issued by emerging market countries, such as those issued by the Republic of the Philippines (ROPs). As ROPs are unloaded, credit spreads will widen and borrowing cost for international debt issuances by the National Government (NG) will rise. If the NG elects to source its entire funding requirements through the domestic market, it may "crowd-out" private sector's borrowing needs. However, investors' response to the uncertainties surrounding the financial difficulties of Greece remained subdued so far, compared to the panic in the credit and money market that was triggered right after the demise of Lehman brothers in late 2008.

After slightly declining during the height of the Greece fiscal woes in the early part of 2010, demand for ROP papers continued to remain buoyant as evidenced by rising ROP prices. This implies that investors seem to focus more on the country's bright economic prospects on the back of healthy macroeconomic fundamentals than the threat of contagion effect of the Greece turmoil to emerging market assets.

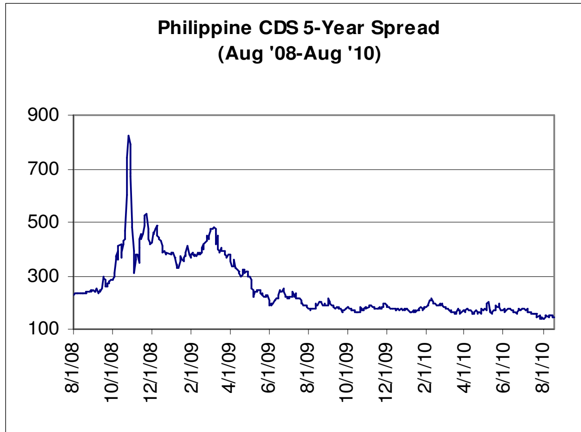


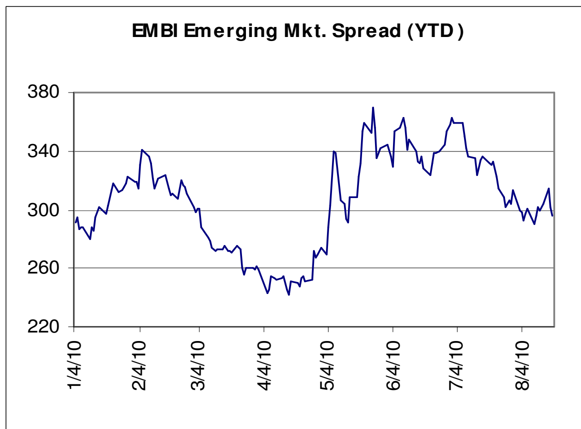
Volatility, as measured by the VIX index[9] reached 45.79 points on 20 May 2010, the highest since April 2009, on fears that the Greece debt problems were escalating to other Eurozone countries. But the increase was still relatively lower against the high of 80.86 index points reached on 20 November 2008 during the height of the global financial turmoil.

The Philippine 5-year CDS spread rose to a year-to-date high of 216 on 08 February 2010 due partly to uncertainties over the Greek turmoil. Similar to the VIX index, the 5-year ROP CDS spread remained much lower compared to the high of 870 reached on 24 October 2008. This is also the case for JPMorgan EMBI emerging sovereign and quasi-sovereign spread index.



[9] The Chicago Board of Exchange Volatility Index or VIX measures the cost of using options as insurance against decline in Standard & Poor's 500 Index





Trade

The Philippines has minimal trade transactions with Greece. In 2009, the country's total exports to Greece amounted to US$14 million, representing 0.3 percent of the total Philippine exports of US$43 billion during the same period. Similarly, importation from Greece was marginal, amounting to only US$13 million during the same period, or 0.3 percent of the total import of US$38 billion. For the first quarter of 2010, trade with Greece remained minimal, with exports contributing 0.08 percent and imports 0.01 percent, respectively.

In a broader context, the Philippines' imports exposure to EU is minimal, comprising an average of 8 percent from 2005 to March 2010. PIIGS[10] countries account (on average) for 22 percent of total EU imports.

The share of the country's exports to EU to total exports from 2005 to March 2010 averaged 22 percent, with exports to PIIGS accounting for 5 percent of the total exports to EU. One possible effect of a euro weakness is that it will reduce demand for Asian exports, which will become relatively expensive.

Contagion risk can also negatively affect trade activities in the Philippines through the financial channel. A survey of some 40 banks done jointly by the IMF and the Bankers Association for Finance and Trade in early 2009 suggested a worldwide decline in the value of trade finance (intermediated through letters of credit, export credit insurance, and short-term export working capital) between January 2008 and October 2008, as well as an increase in the cost of trade credit.[11]

In addition, investments (both portfolio and direct) may also be curtailed by higher risk aversion among investors once the Greece turmoil deepen into a global crunch. If the Eurozone crisis is ring-fenced among the countries affected, the impact on investment in the country appears to be minimal. Portfolio investment coming from the Eurozone accounted to around 60 percent from 2005 to 2009. However, PIIGS account, on average, for only 4 percent of total EU net portfolio investment. FDI exposure, however, has relatively been minimal since 2005 and, starting 2009, has posted negative levels. The combined countries of Italy, Ireland, Greece and Spain account (on average, from 2005 to Q1 2010) for a mere 0.04 percent of total EU net direct investment.

[10] Portugal, Ireland, Italy, Greece and Spain
[11] IMF, Regional Economic Outlook, Asia and the Pacific, May 2009

OFW remittances

The turmoil in Greece is expected to have a minimal impact on OF remittances. For 2009, OF remittances originating from Greece stood at US$200 million, contributing only 1 percent to total remittances of US$17.35 billion. Meanwhile, the EU accounted for 17 percent of the total remittances in 2009, of which 27 percent were accounted for by PIIGS. For the first half of 2010, the share of remittances from EU in general, as well as in Greece in particular, to total remittances barely changed. Remittances from Greece in the first semester of 2010 amounted to US$105 million, or 1 percent of the total remittances of US$9.06 billion. The EU's share to total remittances totaled 18 percent, of which PIIGS contributed 27 percent. Latest data show that the stock of OFs and OFWs in Greece were marginal. For 2007, the share of OFs and OFWs in Greece to the total stock of OFs and OFWs were 0.3 percent and 0.6 percent, respectively.

Conclusion

Foregoing considered, the Philippines has minimal exposures to the Greek market. The Philippines has insignificant trade transactions with Greece, with exports to Greece contributing less than one percent of the total exports for the first eleven months of 2009. Similarly, OF workers in Greece comprise just half of one percent of the total OF population in 2008, and their remittances contributed just a little bit over than one percent to total OF remittances as of February 2010. The consequences of the Greece turmoil in the Philippines will come mostly from the possible contagion effects to emerging market economies – the Philippines included – which, at its worst case scenario, may bring about heightened risk aversion. This, in turn, may lead to repatriation of funds towards safe haven assets, jeopardizing the flow of investments towards emerging market economies and increasing costs to fund their requirements. However, latest data so far point to a relatively subdued market response to the Greek turmoil when compared to the nervousness that gripped the global financial market after the collapse of Lehman Brothers in September 2008.

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