

ERSA Research Brief

July 2015

Four Lessons from the Greek sovereign debt crisis

Co-Pierre Georg, Hylton Hollander, Michael E. Rose¹

Over the past five years the Greek economy has steadily deteriorated to three quarters of its size. Arguably, the inability of Greece to endure the global financial crisis had its roots in an unsustainable fiscal path and a shallow economic system. We study the Greek case to draw some important lessons for South Africa. While South Africa has some harrowing parallels to Greece, two important differences work in our favour: a deep and liquid financial market and monetary policy autonomy.

Debt must be invested, not consumed

The introduction of the Euro in 1999 led to a tighter convergence of sovereign bond spreads between eurozone member states and made it much cheaper for countries with a budget deficit to refinance themselves. Between 1999 and 2009, the Greek economy grew by 33%, but this boom did not lead to productive investments in infrastructure and education. It merely increased real government consumption.

This tendency to increase spending for non-investment related expenditures has also been evident in South Africa. During the early and mid-2000s, both public and private debt accumulated to satisfy the rapid growth in consumption. Thereafter, in response to the 2008/09 global financial crisis, the Greek and South African governments both increased their fiscal support to the economy. Given the recent public sector wage negotiations, the rollout of the National Development Plan, and the weak performance of parastatals, new debt is unlikely to be funneled into productive investments, but rather into consumption--just like in the case of Greece.

Keep parastatals in order

Another trend between the two countries concerns state-owned enterprises (SOEs). In Greece, the state had large stakes in a number of infrastructure providers (ports, banks, water companies, etc.) which ran losses at the expense of future taxpayers.

In South Africa, unprofitable SOEs continue to put pressure on the fiscus, too. In 2014, South African Airways posted a loss of R2.6bn, twice as large as that of 2013. And Eskom recently received a R60bn debt-to-equity conversion of subordinated government loans, and is scheduled for a further R23bn cash injection. Moreover, Eskom's request for a cumulative 25% tariff hike was rejected for the 2015/16 financial year. The unsustainability of the state's stake in Eskom has even led to the prospect of privatization. In the case of Greece, the government eventually sold off many of their SOE stakes in an effort to cut the budget deficit.

¹ All authors are with the African Institute for Financial Markets and Risk Management (AIFMRM) at the University of Cape Town. The first author is also with Economic Research Southern Africa (ERSA).

Unprofitable parastatals not only demand taxpayer's money, they also contribute to a weak rating of government bonds. When bonds are downgraded, a signal is sent to the markets that raises the risk premium on refinancing. This acts as an accelerator effect by worsening the budget deficit precisely when this pressure is not needed. In its decision to downgrade South Africa's credit rating to BBB- (one step above speculative grade), Standard & Poor's cited the government's deepening financial exposure with the parastatal, which already has a guarantee of R350bn. In fact, all three of the major credit rating agencies-S&P, Moody's and Fitch-consider the government's creditworthiness on long term credit as having a downside risk. Greece provides another clear example on how ratings affect refinancing costs: In 2007, when Greek 10-year bond ratings began to slide, yields rose from 4.5% to almost 22% by 2012. By that time, Greece's rating was just one grade above default.

Don't neglect your youth

Another striking similarity between Greece and South Africa is the rise of populist parties on the left, fuelled by the anger of an unemployed and disillusioned youth. Unemployment in Greece has reached South African proportions and youth unemployment in both countries has surpassed the 50% mark.

As it stands, having one out of two young people without a livelihood implies that the other will have to repay the debt accumulated by previous generations. And accumulating more debt to satisfy short-term populist policies will place but an even heavier burden on future generations. In 2014 every South African citizen shouldered more than R23,000 of public debt---almost twice as much as in 2009. It is hard not to over-emphasize how devastating this gargantuan unemployment rate is, coupled with expected higher tax levels, for an entire generation of young South Africans.

Break the link between sovereigns and banks

One of the major problems of the Greek crisis is that the solvency of the Greek banking system and the solvency of the Greek state are so tightly linked. The South African banking system, by contrast, is robust and well capitalized. South African banks are not as heavily loaded with sovereign debt, so the sovereign-bank link is not as strong. This is not to say that there are no risks: the large and sustained current account deficit leaves the South African banking system highly dependent on volatile international capital flows. That said, while Greece has been bound by its commitment to the Euro, South Africa is not subject to the same monetary strangulation of deflationary pressures and inadequate liquidity supply. The South African Reserve Bank's autonomy will be key for maintaining nominal stability and adequate liquidity.

Concluding remarks

In brief, fiscal sustainability will require economic growth, because economic growth broadens the tax base by raising economy-wide earnings. To achieve this, the Reserve Bank must be steadfast in its commitment to nominal stability. At the same time, the Treasury must pursue its proactive approach to fiscal sustainability. This will require the diversion of resources to core social and economic priorities, and the realisation of efficiency gains from social policies, especially in public schooling.