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Is Greece the next Lehmans?

- **The crisis in Greece could pose as big a risk to the global economy and financial markets as the collapse of Lehman Brothers did in September 2008.** In some respects the wider fall-out might even be worse.
- Greece can be seen as the sovereign equivalent of Lehmans. Both are (or were) relatively small players in the global economy. The Greek economy accounted for only 3.0% of euro-zone GDP last year, and just 0.5% of world GDP. Similarly, while Lehmans was a fairly large investment bank and an important participant in some financial markets, it was not heavily involved in lending directly to firms or households. Nonetheless, **the crisis in Greece crystallises the worries about the dire state of the public finances in many countries in the same way that the collapse of Lehmans raised fears of a domino effect throughout the financial system.**
- The fact that a Greek default is even considered possible is a fundamental shock to confidence in the world order. For a start, **Greece has been seen as an advanced economy**, if only by virtue of its membership of the euro-zone. No such economy has ever defaulted on its government debt (at least to any significant degree). **As such, the shock value of a sovereign default in Greece would be much larger than the frequent defaults in emerging markets.**
- What's more, **the pressure will inevitably increase on other weaker members of the monetary union, notably Portugal, Ireland and perhaps Spain and Italy**. That pressure would be all the greater if Greece were to leave the union and then, in time, be perceived to be doing better outside than in. That seems to us to be a real possibility. The contagion from a Greek default could also spread to much larger economies where the public finances are also fragile, including the UK and, perhaps the biggest risk of all, Japan.
- These risks have encouraged the belief that Greece is "too big to fail" and can therefore always rely on bailouts from the rest of Europe and the IMF. Similarly, though, it was assumed that Lehmans would be propped up by the US authorities in much the same way as Bear Stearns was in March 2008.
- Admittedly, **policymakers might conclude from the Lehmans episode that Greece cannot be abandoned.** However, the German public in particular is taking some convincing and the Greek people themselves may decide that the price of international support – a massive fiscal tightening and prolonged recession – is simply too high. (After all, the fall of the Berlin Wall was the result of people power rather than the considered plans of the East German government. More recently, the electorate in Iceland has vetoed government proposals to repay emergency loans from the UK and the Netherlands.) **The international community might therefore rally behind Greece and delay the crunch for a while longer, but the crisis will not pass until the Greek economy is back on its feet. That will take years, not months.**
- What's more, even if Greece is rescued, the appetite (and IMF resources) for another bailout would surely be limited. **Greece might therefore end up as the next Bear Stearns – the last to be bailed out before patience finally runs out, and some other country (perhaps in the euro-zone or perhaps in Emerging Europe) becomes the next Lehmans.**
- **The upshot is that the markets are right to be increasingly worried about the global fall-out from the crisis in Greece, and may not be worried enough.** It *might* be argued that the world economy is now in better shape to weather a major financial shock than it was in late 2008. Business and consumer confidence are rising, rather than falling, and property prices are no longer as obviously over-valued. Banks are also better capitalised and might be more willing to continue lending to each other, and to firms and households, even if they are more reluctant to lend to governments. The authorities have the recent experience and facilities to hand to keep liquidity flowing if required.
- But this all seems complacent, for at least three reasons. First, **the recent economic recovery from the global financial crisis has been driven by a massive policy stimulus that cannot be repeated.** Interest rates have already been cut to near-zero and, while they are likely to remain low for much longer than generally anticipated, the scope for further cuts is obviously limited. The impact of an additional round of unconventional monetary policy measures will also be smaller than before.

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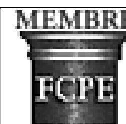

CAPITAL ECONOMICS

- Indeed, growing worries about sovereign credit risk will only increase the urgency to reverse the *fiscal* stimulus. Greece has stood out because it has proved impossible to regain the credibility lost when it was revealed that the official figures on the public finances were much worse than originally reported. But Greece is not alone in facing a major fiscal tightening – in many other countries, notably the UK, the differences in degree and timing are not that great.
- Second, **the legacy of the global recession still lingers in the form of massive amounts of spare capacity, including high unemployment**. This means that consumer spending remains vulnerable to any new shock, whether it is a slump in financial markets or the growing recognition of the scale of public spending cuts and tax increases that will be needed. This spare capacity is also maintaining the downward pressure on wages and prices, so another financial shock could tip the world into widespread deflation. In turn this would compound the fiscal crisis, as tax revenues would fall and debt/GDP ratios soar.
- Finally, any upward pressure on benchmark government bond yields would raise borrowing costs throughout the economy, including corporate bonds and mortgage interest rates. The balance sheets of the banks would also take another hit, reducing their capacity to lend. **The global financial crisis has only been partly resolved by transferring it from the banking sector to the public finances.** A sovereign credit crisis could feed back into a renewed banking crisis, as the value of the government bonds on bank balance sheets falls and the worsening public finances leave no room for further bailouts.
- The wider implications of the Greek crisis could therefore be profound. **The reaction so far in government bond markets has at least been partially reassuring**: rather than yields rising across the board, those in markets perceived to be relatively safe have fallen (the US, Germany) even as those in peripheral markets (most obviously Greece) have surged. The chances of a serious crisis of confidence in the creditworthiness of the US or Germany are still remote and we continue to expect yields there to fall further as the global economic recovery falters and monetary policy is kept loose for longer. (Our end-2010 forecast for 10-year US Treasury yields remains at 3.0%.) But we are increasingly concerned about developments in Japan and will continue to analyse these closely within our Japan service.
- **The dollar is also likely to strengthen further**, just as it did in the wake of the collapse of Lehmans. Indeed, safe haven demand for the US currency is likely to be even greater than it was in late 2008 given the concerns over the future of the euro and the much worse state of the public finances in Japan. We still expect the dollar to rise to $1.20 against the euro by end-2010, and to 100 yen.
- But the uncertainty generated by the crisis in Greece is undoubtedly negative for equity markets. We have long had an end-2010 forecast of 1000 for the US S&P 500 based on our expectations that the economic recovery in the US would ultimately disappoint. For now are sticking with that view, despite the problems elsewhere, because the recent news from the US has actually been a little better. However, **European equity markets look increasingly vulnerable to persistent worries about the economic and fiscal outlook**.
- **The Greek crisis could also be the catalyst for a long overdue correction in the prices of (most) commodities.** Many participants in these markets seem to assume that the world economy is returning to the strong growth that fuelled the commodity price boom from 2004 to 2007 as if nothing has happened in the meantime. In contrast, we continue to expect big falls in commodity prices in the second half of this year, with oil back at $60 per barrel and copper below $5000 per tonne. While good news for consumers, a collapse in commodity prices would be another shock for financial markets. It would be *bad* news for many emerging economies, particularly Russia and across Latin America.
- Finally, **it is now or never for gold**. Safe haven demand should be strong and rising given that gold is not dependent on the creditworthiness of any government. Despite this, current gold prices of around $1163/oz are still some way below the peak of $1227/oz seen in December last year. (Gold is hitting record highs in terms of other major currencies such as the euro, but this reflects the weakness of those currencies rather than the strength of gold itself.) Gold's failure to set new highs in dollar terms most likely reflects the resilience of the US currency, still-low inflation and the lack of any new impetus from central bank buying. Prices would spike higher in the event of an actual Greek default. But we continue to expect gold to fall back towards $900/oz by year-end as the dollar rises further and global *deflation* fears return.

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