Of BRICs and PIGS

First there were the BRICs – Brazil, Russia, India and China. Emerging markets that are elbowing their way onto the global economic stage, chipping away at the dominance of the traditional developed countries (US, UK, EU). Their status was hugely enhanced by the credit blow-up and subsequent recession. They did not have to bail out collapsed banks and their recession (if any) was short (Russia being the exception).

Now we have the PIGS – Portugal, Italy, Greece and Spain. Like banks that borrowed too much and could not meet commitments, these countries have also borrowed too much over the years and there are now fears that they will default on their debts.

If a bank goes down the government can bail it out but who bails out a government when ít fails?

Greek and German squabble

The country that is in the deepest trouble, Greece, was hoping that the EU would come to its aid. Germany is by far the biggest economy in the EU and thus the one that would make the biggest contribution to a bailout. But Germany's Mrs Merkel has put her foot down and simply said no.

German public opinion is overwhelming against sending hard-earned German money to the South to what a German magazine has called the "swindlers" of Europe. The previous Greek government falsified budget numbers and misrepresented the budget deficit, presenting it as smaller than it actually was. Hence the "Swindlers". Greek media countered by altering the famous image of the charioteer on top of the Brandenburg Gate to now wave a swastika.

The Greeks claim that the Germans owe them because of the German occupation of their country during World War II, and allege that Germany at that time looted all the gold in the Greek Central Bank. The Germans deny it and point to the war reparations they paid.

A very sophisticated European debate … reminds one of the ANC Youth League.

It is worth noting, however, that German civil servants have to work to age 67 before they can retire whilst the Greeks can retire at 53. It illustrates the difference between a more sober and a more profligate lifestyle. Germany passed a constitutional amendment forcing balanced budgets in the next decade. Greece has run annual average budget deficits of 7,8% of GDP since 1988.

Enter the bond market

With no help forthcoming from the EU, the Greeks had a gun to their head in the form of €20 billion of Greek debt that matures by May 2010 and needs to be rolled over. That is apart from more debt that must be incurred to finance budget deficits. So there is some urgency.

But why would investors buy Greek bonds if there is a fear that the Greeks would default? So Greece had to convince bond market investors that the country will not default and is capable of servicing its debt. The only way to do that is to improve the health of public finances.

Greece has now taken a lot of bitter medicine. Starting in January they submitted 3 budget plans which, combined, envisage reducing the budget deficit from 12,7% of GDP to 8,7% this year. Back in January nobody was impressed by their first attempt as the whiff of manipulated numbers swirled around once again. They were suspected of using over-optimistic growth assumptions. So they tried twice more, each time cutting expenses and raising taxes, and as the pain worsened, the credibility of Greek budget plans improved.

This has helped because last week Greece entered the bond market and offered ten-year bonds to the value of €5 billion. They were snapped up with enough buyers for three times the amount. But the interest rate that the Greeks had to pay almost doubled to 6.25%. If old debt is rolled over, and new debt acquired at these higher rates, the interest burden will become quite costly.

Greece needs to refinance €10 billion in April alone. So watch this space.

Contagion

The Greek tribulations have focused the spotlight on other countries in Europe with high debt and high deficits. Portugal, Italy and Spain are the ones that stand out. They will also have to take remedial action to get their public finances in order so that they can borrow on the bond markets.

How far will this contagion spread?

Some commentators expect the UK to join the list of PIGS. The biggest bond fund manager in the world, Bill Gross from Pimco, has warned (bond) investors to stay away from the UK. The UK fund manager Schroders has warned that the UK is fast approaching "downgrade territory". That country has to sell 550 billion pounds of bonds over the next 3 years – a credit downgrade cannot be good news.

Whoever is elected in May will have to take some very unpleasant decisions. The pain of austerity is just about to begin.

Part of the same story

In their new book, *This time is different,* Carmen Reinhart and Kenneth Rogoff trace financial crises over the last 800 years.

The bottom line is that debt bubbles are followed by banking and then sovereign debt crises. The authors found that after a banking crisis government debt rises by at least 80% in three years (we have seen that); growth slows (seeing that too); and a banking crisis could morph into a government debt crisis (seeing that in Greece now).

Each time people believe it will be different, each time the cycle plays out the same way. In the end the debt has to be worked off, through combinations of austerity, default and inflation – and each has its own consequences.

South Africa's position

SA worked down its debt load from 48% of GDP in the nineties to 23% last year. Thank heavens for those three years that Trevor Manuel ran surpluses and used it to pay down debt.

We learnt our lessons in 1996 and 1998 – the Rand depreciated, interest rates came under pressure, growth suffered. We then cleaned up our public finances. More recently we did not have to bail out banks.

What we are doing is incurring a lot of debt to get us out of recession and stimulate growth. SA's debt load is budgeted to deteriorate from 23% of GDP to 45% in 2015. State spending, also infrastructure spending, is kept unchanged in spite of a collapse of tax revenue; taxes have not been raised; and the difference is made up with higher borrowings. If it works, we will get 3,5% growth and work down the debt; if it does not, we will join the PIGS.

Granted, SA's debt at 45% is a lot lower than the PIGS' 100% of GDP, but our long-term interest rates are also a bit higher. So far we have no problems with the bond markets, the country successfully placed an international bond last week. But as the deputy minister of finance warned on Friday, fiscal discipline will have to remain the top priority.

So What?

- Sovereign debt problems can play havoc with currencies and we have indeed seen huge changes in the values of the euro, pound and dollar. The upshot for SA is that the rand tends to be stronger than our exporters would like.
- Globally, indebted countries will have to reconcile themselves to slower growth and declining living standards. That will cause political tension and bring protestors onto the streets as it already has in Greece and Portugal. At some point the US and the UK will also have to make painful cutbacks.
- SA will have to watch its public spending very carefully and reduce the deficit as quickly as it can.