

The Darker Side of Paradise: The Financial Crisis in Greece

A recent report by the European Union (EU) has uncovered under-reporting of the fiscal deficit by the Greek Government for years. Based on what is now known about Greece's finances, it never would have been permitted to join the EU by the other member countries. Currently Greece's deficit spending equals about 13.6 percent of its Gross Domestic Product. By comparison, the US Government spending deficit is about 5 percent of GDP.

Greece got into this pickle by having the most generous retirement programs of any country in Europe, if not the world. In Greece almost any private sector worker can retire at age 55 with full pension if he or she can categorize their job as "dangerous" or "stressful". The explosion of retirees coupled with the dearth of births has led to a situation where Government revenues are not increasing while Government spending goes through the roof.

A second factor is the fact that tax evasion is a national sport. This tradition goes back to the Romans and accounts for an estimated ten percent of the Greek economy being unreported and untaxed. While taxes are high in Greece, the ability to tax the underground economy in itself will not reverse the dynamics of the situation.

At first the International Monetary Fund (IMF) offered to assist in the crisis. The EU, led by Germany, rejected the assistance on the grounds that Greece was an EU country and that it would be settled by the European governments. After hearing loud dissent by German voters resentful of being asked to subsidize the Greeks' lifestyle, Germany changed its mind regarding IMF assistance. The bailout of Greece will become a joint affair.

The problem is that no one wants to play the heavy. Everyone knows that Greek Government spending and benefits will need to be cut, along with public sector salaries. No one wants to be the party to institute the cuts, thus the role of the IMF.

While three other European countries are mentioned as being in similar straits as Greece (Portugal, Spain and Italy), none of these countries have the cost structure of Greece. In the case of Portugal and Spain the problems have more to do with real estate expansion, especially expensive vacation homes sold to foreigners. Italy's problems are more parallel to those of Greece but are nowhere near as chronic.

The larger question is whether the situation in Greece is a prologue for other mature countries that have aging populations and slow economic growth. It seems axiomatic that retirement ages and cost of living adjustments will have to be reduced for all countries with unfunded retirement liabilities. The unknown is whether benefits of current retirees will come under downward revision. One plan being discussed is making all benefits in excess of one's contributions taxable. This would have the effect of recapturing the retirement payments of those in higher income brackets while leaving the distributions for those in lower brackets.

The situation in the United States is better than that of most countries, relatively speaking. Compared to other developed countries we have higher population growth and until recently a more liberal immigration policy. Both of these factors have the effect of lowering the average age of the population. While the US still has trillions in unfunded future Government obligations in the areas of retirement and health care, among others, these numbers are at present estimates and can change with changes in policy and population. Too, a growing population permits tax revenues to come in higher than estimates, making the estimates of unfunded obligations as likely to go down as up. For countries such as those of Western Europe as well as Japan and China, the aging of their populations is set to occur far faster than in the US with the attendant social costs harder to bear.

Because of the politically sensitive nature of the matter, nothing is expected to transpire domestically with regards to unfunded mandates until after the November elections. Typically a committee is formed to provide political cover for such unpopular decisions. A historical precedent is the committee formed to close an excessive number of military bases in the 1980s. As no politician was willing to vote for the closing of a military base with the attendant loss of jobs, a commission provided the cover needed to authorize the closures simultaneously so as not to single out any one district or state.

The case of Greece is a study in what happens when hard political questions are not addressed. Hopefully the situation there will be a warning for other countries facing similar circumstances. If not it will be a road map for their own reconstruction.

The Economy

Economic activity has picked up over easy comparisons of last year at this time. While job creation is slowly becoming more pronounced, corporate profits have gone up sharply due to the operating leverage present in most firms.

As the year progresses comparisons to 2009 will become more challenging. Also, at some point companies will have to add more workers and other cost factors to accommodate their increases in revenues. This will cause revenue growth to more closely approximate the growth of the economy.

While there is less talk of a double-dip economy, there will be greater challenges to overcome when the twin stimulants of Federal Reserve purchases of mortgage securities (already terminated) and the decline in the deficit (expected next year) occur. While the economy is stronger it is not robust but rather fragile.

Interest Rates

Interest rates have been at record low levels for over a year. With termination of the two stimulus programs listed above, interest rates are expected to drift higher.

The prospect calls for money market funds to yield 2-3 percent by this time next year. Longer term rates will go up less as the yield curve flattens in response to loan demand due to economic activity. This will lead to some pressure on bank earnings as depositors become better compensated.

Inflation

Two countries are taking steps to address inflation at this time. Brazil has raised its interest rates to reduce speculation while China has ordered its banks to reduce loan volume.

In the US inflation continues to be fairly dormant. Until wages begin to rise it is expected to remain in the 1-2 percent range.

The Stock Market

A combination of stronger than expected earnings and a dearth of investment alternatives has propelled stocks forward so far this year. The investment issue is whether these factors will continue in the same proportion into the future.

In the short run stocks would seem to be vulnerable to unexpected negative events more so than normal. Over time the environment for stocks appears to be good until the supply of stock begins to meet demand. At present this does not seem to be an issue. New issue offerings are still subdued and most bond yields do not provide compensation in excess of projected inflation. While future appreciation will surely slow, the relative rate of return for stocks should continue to outperform investment grade bonds and cash.

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