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Bad news for everyone

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THIS note briefly traces out the implications of the Greek debt crisis (and bail-out) for different regions of the world.

1. Greece and the PIIGS: Greece has been given about a year to set its house in order. It is unlikely that Greece can actually accomplish the onerous conditions imposed under the IMF programme—the real question is whether there will be measurable progress towards those goals, including a reduction in the budget deficit and reforms to labour and product markets.

If there is progress, the EU and IMF could continue to support Greece after a year and help work out an orderly restructuring of Greek debt. This would be less painful for Greece and limit contagion effects. If Greece shows little progress, then we will have a messy restructuring, with much greater potential of regional contagion.

In either event, this sovereign debt crisis is going to increase the level of unease about rapidly rising debt levels in other advanced economies. Down the road, this could foster further instability in world financial markets.

2. Europe: The long-term viability of the euro project is going to be under the spotlight and in the future investors are going to discriminate more carefully amongst bonds issued by different countries in the euro zone. This crisis has exposed a fundamental structural problem —divergent productivity growth across the eurozone economies and the lack of an effective enforcement mechanism for fiscal discipline, obviously complicated by the absence of an intra-zone monetary policy adjustment mechanism.

The possible solutions are (i) a drastic restructuring of the economies on the periphery in order to boost their competitiveness or (ii) rising transfers from the core to the periphery. It is not obvious that Europe has the political will for either solution, but the costs of the euro project are going to become increasingly apparent and bring matters to a head.

3. China: The debt crisis will hurt short-term growth prospects of European Union countries and keep the euro weak relative to the dollar, creating a double hit on prospects for China's exports to its most important foreign market. This is likely to delay a move on the renminbi, especially if ripple effects of the European crisis lead to a further strengthening of the dollar—and, by extension, the renminbi—due to the safe-haven effect These developments have fortified the hands of those officials in China who are stoutly opposed to renminbi appreciation for fear that it could dampen export and employment growth.

4. Other emerging markets: Once the initial wave of panic related to the Greek debt crisis passes, and with continued low interest rates in advanced economies, emerging markets with good growth prospects could face another surge in capital inflows. With stunted growth in their advanced country export markets and rising exchange rates, their industrial sectors could come under sharp pressure. Chinese currency policy will of course make matters worse as it will lead to more inflows into some of these economies (especially Asian emerging markets) as a proxy play on the renminbi and further worsen their external competitiveness position.

5. Global economic recovery: The turmoil in world currency and financial markets and a weakening of one of the key economic regions in the world could drag down global growth. The best-case scenario is that Europe won't be a drag on growth in 2010-11. It is difficult to envision the region making a significant positive contribution to world economic growth over this period. The US goal of doubling exports in the next five years is going to be greatly hindered by the dollar strength and weaker import demand from Europe, which is itself going to be looking to exports to pull itself out of the slump.

6. International monetary system: Governance reform at the IMF to give the emerging markets a more appropriate level of presentation, which is already moving along at just a glacial pace, could grind to a halt. The crisis has exposed deep fractures within Europe and the prospects of European countries coming together to consolidate their voting shares at the IMF now seems more remote than ever.

In short, the Greek debt crisis and its ripple effects are bad news for all corners of the world and there is a strong collective interest in containing the problem. The risk is that a weak containment strategy limits the immediate damage but leaves the underlying problems festering and creates bigger problems in the future.