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The Greek tragedy deserves a global audience

Euro-zone countries have borrowed a record €110bn from financial markets since the start of the year, pushing up the cost of debt and forcing nations with the weakest public finances to pay a heavier price for their ballooning deficits. Interest rates, investors will demand to lend to Greece and other countries such as Portugal, Spain, Ireland and Italy, will rise further.

The problem of sovereign risk is just beginning. The project of European monetary union is entering the most dangerous phase in its history. Before answering the question what the euro-zone will need to do to survive the strains ahead, let's first focus on Greece.

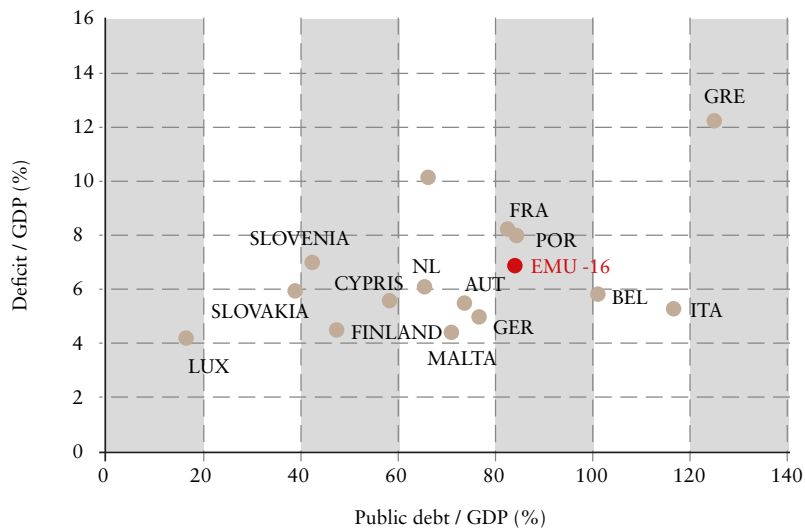
What is the "Greek tragedy" all about?

When Greece joined the euro in 2001, its membership was a boon. The underpricing of default risk during the credit boom gave Greece easy access to longer-term borrowing as bond markets had no longer to worry about high inflation or devaluation. Lower interest rates also resulted in higher private spending. Until 2008, the economy grew by an average 4% per year. As a consequence, once Greece was safely inside the euro, it relaxed its fiscal discipline.

Greece and some other peripheral countries have lost competitiveness within the zone, as unit labor costs powered ahead over the last decade. Rigidities in labor and product markets have contributed to persistently higher wage and price inflation than in the rest of the euro area. Rising fiscal deficits have pushed up borrowing costs, adding to those deficits. The net result has been a twin deficit problem; making Greece the only of the vulnerable euro-zone member countries to have both a high fiscal deficit and high debt. Other countries with large fiscal deficits are Ireland (12.2% of GDP in 2009) and Spain (9.6%). But, while net public borrowing was 86% of GDP at the end of 2009 in Greece, according to the OECD, in Ireland and Spain it was only 25 and 33%, respectively. Meanwhile, Italy, with a net debt ratio of 97%, had a deficit of "only" 5.5%. Portugal is in the middle, with net debt of 56% of GDP and a deficit of 6.7% of GDP. Thus, the challenge for Greece is larger and more urgent than for the others.

A big structural fiscal tightening as announced on January 14th will generate a deep recession. The ambitious plan to cut its budget deficit from 12.7% to 8.7% of GDP this year, and to below the 3% ceiling for euro-area members by 2012 was not really welcomed. Spreads on ten-year government bonds over German Bunds, a measure of the perceived risk that Greece may default on debt repayments, edged upwards.

Forecast of public debt and deficit in 2010



The more fundamental problem

Even if a credible solution for the Greek problem is found, the greater question will remain: how to handle the growing productivity difference between its workforce and that of Germany? Indeed, before the Euro was introduced, if a country's productivity growth was stronger than a neighbors' one, then, over time, the market forced the latter into devaluation of its currency, hereby ensuring competitiveness. But what happens now that the exchange rates between these countries are irrevocably fixed?

In the absence of a common fiscal policy, the potential problem of a currency union with a unique monetary policy is that countries or regions with a less competitive workforce are forced to deflate prices to become competitive again.

Or deflating prices impacts businesses via smaller margins, and could potentially lead to a prolonged and deep recession, because final demand will be postponed. The alternative would be to create inflated prices in the most competitive countries. This is not realistic. There will be no way to convince Germany, the most competitive country in the Euro area, to embark on a strategy for higher inflation.

What are the solutions put in place in the United States, where some States like California are also virtually bankrupt? Tax receipts from a more competitive state will subsidize less competitive States. The mobility of labor is higher, and workers move from where there are no jobs to States which are more productive. In other words, the solution is one of transfers; either transfer of wealth through for example redistributive taxes or transfer of labor from the least to the most productive. Now, as it turns out, labor costs tend to be somehow sticky around the world, but are especially so in Europe.

Another example may be German reunification. The former west, through special taxes, transferred massive wealth to the former east; and workforce flew from the much less competitive east to the much more productive west. The process was accelerated by impressive reduction in labor costs in the East, either by firing people or reducing substantially their wages. The process took time and was painful as it resulted in high unemployment and stagflation in the former East Germany. As a consequence, the budget deficit increased in the West and German monetary policy was largely expansive.

The current global context makes any solution much harder to find

As I already insisted, when productivity growth between two countries starts to diverge, either exchange rates, or salaries, have to adjust to balance competitiveness. There is another link between imbalances and exchange rates. Previous exchange-rate systems had been linked, directly or indirectly, to a standard, fix reference, mostly gold. The aim was to limit the printing of money to finance deficits. As a consequence in such fixed exchange rate systems, it was difficult for countries to support deficits, be it internal or external ones, for too long. By anchoring the currency, governments forced the real economy to absorb shocks. In the euro zone of today, this reference is the efficient German export industry. That implies the need to limit deficits and wage growth, or even to freeze both. In the aftermath of a financial crisis with a huge negative impact on potential GDP growth, regaining part of the lost productivity while credibly reducing public and private deficits risks not only the economy to fall back into recession, but may rattle the foundations of social cohesion within countries and in the EU globally. A social crisis on top of the financial or economic crisis is the last think any of the countries would need or could digest.

On the other hand, the natural desire for social cohesion must not be abused to justify the protection of “insiders”, those in permanent jobs, in trade unions or in privileged professions. The cost of protecting insiders would largely fall on “outsiders” the unemployed, especially young people, destroying potentially the very social cohesion that the policy is meant to preserve.

If Greece is to kind to the insiders, especially the public-sector workers, it will struggle to find buyers for its bonds. If bond markets would close for Greece, the country will face bail-out or default. Neither will contribute much to social peace.

A solution from the inside or the outside of the European Union?

A bail-out by the euro-zone as a whole would create a monstrous moral hazard for politicians. If a country would let its public deficits increase to default, it would simply be saved by a bail-out? To avoid such moral hazard, some observers favor a solution outside the European Union. But, what would an exit from the euro-zone imply for the exiting country? Here are some likely consequences.

Nominal interest rates would rise, leading to higher costs of servicing the public debt and undermining fiscal adjustment. The rise in nominal rates would be the consequence of expectations of further devaluations of the new currency, rising inflation expectations and the lack of the credibility of monetary policy. Both currency-risk and country-risk premiums will rise. Any devaluation of the new domestic currency against the euro would increase the debt burden as existing euro-denominated debt would become foreign-currency debt.

The costs of converting currencies with the remaining members of the euro-zone would be re-introduced, inhibiting trade and investment. The exchange-rate uncertainty with the euro area would increase the costs of conducting business.

How could a solution from the inside of the European Union look like?

The treaty governing the European Union includes a “no bail-out” clause, forbidding countries from assuming the debts of others. Other treaty clauses, however, may allow for aid to an EU state in trouble. So what could be workable solutions?

One remedy would be for Greece to arrange a bridging loan from another EU country in good credit, such as Germany for example. To ensure that “good” money is not thrown behind “bad” money, such a loan must have constraints attached implying that the loan-giving country would have a word to say in establishing the budget of the loan-receiving country. This is hard to conceive.

Calling in the IMF would be an alternative. As the IMF already helps countries like Hungary, and has experience of restructuring debt with Argentina; calling in the IMF would make a lot of credible economic sense. To turn to Washington, where the IMF is located, for aid, would certainly be some kind of humiliation for Europe, as it would indicate, that Europe is not strong enough to deal with its own problems.

If Europe is to pride to call the IMF, it will have to create its own European Monetary Fund. The fund could set up a loan facility financed by EU-backed bonds, issued whenever a need arises. It would mean that the countries backing the bond will be liable if the bond would not be repaid. The solution could be implemented whenever bond markets would be closed for a member state. An alternative to the same idea could be a pre-defined type of insurance system. Member states would be obliged to buy, before any crisis, an insurance contract issued by the European Monetary Fund through paying an insurance premium. The level of this insurance premium could be based for example on a country's deficit, deficit projections and / or debt level. The higher the deficits or the debt, the more expensive the insurance premium will be. The money raised would reflect the overall sovereign risk in the system and could be used to bridge a loan to a member state for which bond markets are closed. In order to make the system credible and sustainable over time, each time a member state would need help from the Fund, the Fund would take over with the acting government the monitoring of the return to fiscal discipline and stability in order to allow for transparency in the process.

Impact on financial markets

Letting Greece default is not an option. If Greece would be allowed to go under, the cost of borrowing for other troubled euro members would shoot up. As such sovereign credit default has risen in some of the largest economies, not only Spain and Portugal, and the issue of sovereign risk may just be in its beginning.

But higher risk premiums on government bonds will almost invariably raise the risk premiums for other assets, notably equities, and even corporate bonds as credit spreads are already very tight.

As a sector, European banks look particularly weak as they started to take on huge bond positions on their books during 2009 as a result of the abundant liquidity put at their disposal by the European Central Bank.

Finally, uncertainty about the future of the euro-zone is undermining the euro. This is not necessarily a bad thing: the euro has been over-valued against the dollar and the recovery in export-led Germany may already have stalled. A disorderly surge in the dollar, perhaps compounded by the unwinding of carry trades, could cause panic selling across a wide range of riskier assets. Commodities look especially vulnerable, given the weak growth outlook. Indeed, even gold has struggled, despite its traditional safe-haven status, as the dollar has perked up.

Conclusion

Given all the benefits of the EUR as a single currency, we should not forget that the currency union is less about economics than about politics. The political will to keep the project going is strong. But for the Euro to survive in its current form, the most efficient and productive countries, like Germany for example, will have to pay in the form of wealth transfers, even if the less productive countries commit to fiscal discipline. This is not an easy pill to swallow!

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