SPECIAL FX

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Germany: The Unnamed Co-Conspirator

For the better part of the past four months, Greece has been the center of the European maelstrom. It tried concealing the full magnitude of its deficits and debt for years. The proverbial chickens came home to roost when George Papandreou led the Socialists to electoral victory and when he went into the Treasury and found the cupboards were worse than bare.

Europe's AIG Moment

The markets and, seemingly, most Europeans have very little sympathy for Greece. The situation it finds itself in today is its own doing. Yet the risk of financial contagion is forcing Europe to do much soul searching in the same way the US policy makers did when it came to taking over AIG.

It was not about AIG any more than it is about Greece. US policy makers deemed the cost of taking over AIG was less than the likely cost of letting it go under. AIG was supported to minimize the systemic risks that it posed. It was not so much that AIG was too big to fail, but it was too interconnected.

Greece is to Europe what AIG was to the US. Greece accounts for less than 3% of the euro zone's GDP. Proportionately, it is similar to Massachusetts (GDP) relative to the US (GDP). The channel of contagion that most have focused on is through the foreign ownership of Greek bonds.

Some European officials, stricken with a severe bout of what the German's call schadenfreude (taking pleasure at someone else's misery), were nearly gleeful at the start of the US subprime and derivative crisis. Yet within the context of Europe's political economic culture, it essentially did the same thing in roughly the same amount. And this same thing is mispricing risk.

Before the crisis, primarily European banks lent money to countries in the periphery of Europe at extremely narrow interest rate spreads to the benchmark, which in Europe are German bunds rather than US Treasuries. Greece could secure long term financing by selling bonds for as little as 30 bp more than Germany. Today it is near 300 bp.

Can't Risk a European "Lehman"

According to the Bank for International Settlements, as of the end of September 2009, German and French banks alone had a little more than $100 bln of Greek exposure. This exposure is not only limited to government bonds, but also includes corporate bonds. Add Swiss banks and it brings the exposure up to $160 bln. By comparison the US and UK together have about $28 bln.

Given that many European banks are still dependent on various government (and central bank) assistance, and the Lehman experience with the unintended and unforeseeable consequences, make European policy makers reluctant to see Greece restructure its debt (the sovereign equivalent of bankruptcy). And recall that in several of these European countries, the banks' assets are larger than the countries' GDP, sometimes by a factor of 3-4. The first banking crisis was sufficiently ruinous. Another one now, before the first one is truly over, could very well become an existential crisis.

The experience of the 1997-1999 Asian financial crisis suggests that other countries in Europe who share some of Greece's macro-economic characteristics may also be susceptible to the same type of market reassessment of risk. Portugal and Spain are the next obvious candidates. The BIS data shows that German and French banks alone have more than $400 bln of exposure to those two countries. Throw in British and Swiss banks and the exposure is closer to $500 bln.

Only Half the Story

In order to avoid the wrath of investors, the weaker credits in Europe, like Spain, Portugal and Ireland are cutting spending and raising taxes. With Europe's insistence, Greece has had three rounds of belt tightening in as many months.

We are told by economists, policy makers and the media that this is what is needed. People have to live within their means. There are limits, even if not known a priori, to fiscal policy and living on credit. And so it is, but this is only half the story and only grasping half produces short-sighted policy and could wreck even well thought out investment strategies.

The other half of the story is about economic contagion as opposed to financial contagion, which is where the focus has been. The irony is that the steps being taken to minimize financial contagion will increase the risk of economic contagion.

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As we saw, the channel of financial contagion lies with cross-border bank exposures. It is a debt for the borrower/issuer, but an asset to the lender/buyer. The channel of economic contagion in Europe is trade.

The fiscal contraction among the Mediterranean countries (Spain, Portugal and Greece) and Ireland means that aggregate demand will be weak, with downside risks. The demand from countries that are living beyond their means is someone else's exports. In Europe's case, this is often Germany.

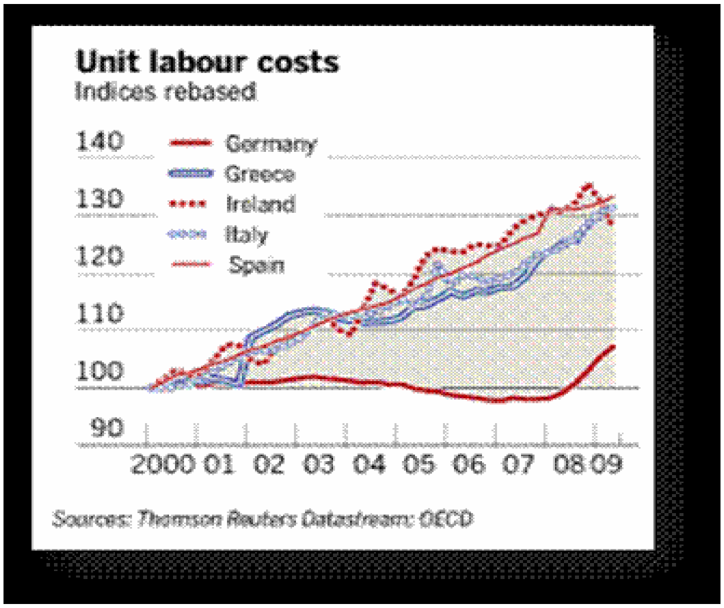
Germany is often among the top two exporters in the world. Last year it slipped behind China, exporting a little more than $810 bln of goods and this is after a 14.5% decline. Germany exports around 40% of its GDP, which is roughly the same proportion as China.

In 2009, German exports to Greece, Spain, Portugal and Ireland, whose combined GDP is about $2.7 trillion, exceeded its exports to China and Japan, where the combined GDP is more than $9 trillion. And Italy, which also has debt and deficit issues, receives even more of Germany's exports. The fiscal austerity that has already begun is not simply in the Mediterranean and Ireland, but many eastern and central European countries as well.

Austria and Belgium have high debt/GDP ratios (and their banks have the largest exposures to the Baltics). Taken together these euro-zone countries—Greece, Portugal, Spain, Ireland, Italy, Austria and Belgium absorb a full quarter of Germany's exports.

Competitiveness and Co-Dependency

If Greece is the European parallel to AIG, then perhaps the apt parallel for Germany are the technology companies, like Lucent that used to finance customer purchases of their goods. When many of those customers, often internet companies began failing, companies like Lucent not only lost future revenue, but lost its investment (loans) as well.



German bank exposure to Greece could have financed about 5.5 years of Greek purchases of German goods. This co-dependency can work as long as Greece has access to cheap credit. That is what changed. And it changed, not during the crisis, because interest rates were very low, but as the recovery began taking hold and the peak in liquidity was either past or at hand and risk was more appropriately priced.

Germany only consumes 60% of what it produces. It sells the rest abroad. And in order to do this not only requires certain behaviors, like living beyond one's means, of one's neighbors, but also requires a certain domestic policy.

Germany has contained unit labor costs over the past decade. They were essentially flat for much of the past decade. Few countries can do that. Countries in the periphery of the euro-zone shown here are not alone. It is equally true for nearly all the Europe.

The European debt crisis, if it is that, is ultimately a crisis of competitiveness. Greek unit labor costs were not just rising while Germany's were flat but they were rising at an average pace of twice the euro-zone as a whole.

Last year Greek unit labor costs rose by 2.5% and were expected to rise by nearly 1% this year before the austerity measures. In contrast, for example, Ireland's unit labor costs fell by almost 2% last year and could fall by 4% this year, according to some forecasts.

What is not yet appreciated is that the restructuring of peripheral Europe that appears to be already underway to some extent will require the restructuring of Germany. The emphasis on the sin of debt obscures the co-dependency with the creditor. Fixing the periphery of Europe's competitive challenge means that Germany's customer-financing, export-driven model, predicated on other countries consuming more than they are producing, may be challenged. A steadily declining euro will help facilitate this transition, and while countries don't always get the exchange rate they need, this particular time, it just may work out that way.

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