What Ails Greece Ails Europe

Greece lies at the center of Europe's maelstrom. The proximate trigger was the election of a new government last October that had the audacity to reveal a deep dark secret—Greece's deficit was three times larger than previously acknowledged.

Prime Minister George Papandreou was contrite and has cobbled together a general plan, effectively reversing many of his campaign promises; claiming to reduce the deficit from 12.7% in 2009 to 3% in 2012. A Herculean labor if there ever was one.

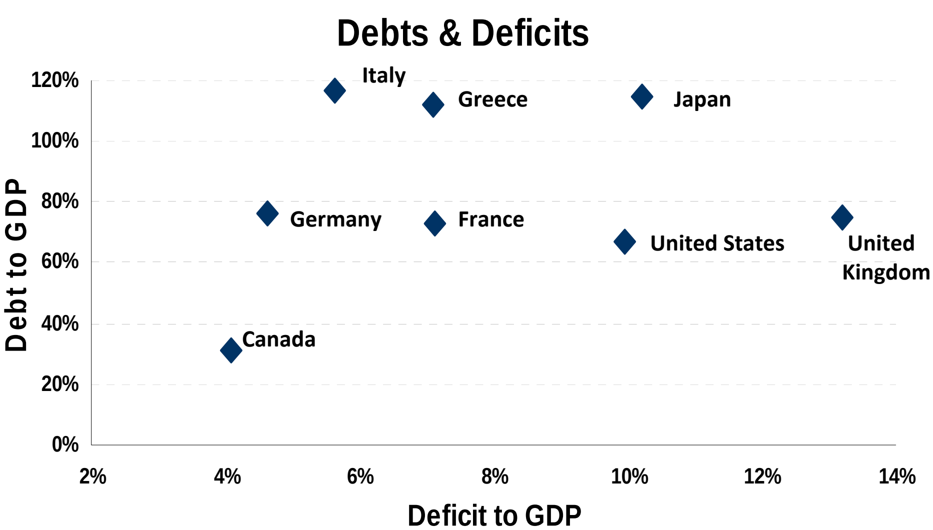
News of the fiscal blow out initially weighed on Greek debt instruments and cost of insurance against default (credit default swaps) rose. Anxiety seemed to abate into the end of the 2009 and the first part of this month. Interest rates eased. There was some relief that Moody's cut its rating for Greece only one notch on December 2nd to A2 (Fitch and S&P cut their ratings to BBB+ earlier). The premium over Germany fell. The cost of insurance slipped.

There will be Blood

Things have turned ugly in recent days. Interest rates have soared in Greece; the premium over Germany widened sharply; the cost of insurance sky-rocketed—to roughly twice what it was at the start of December. Euro zone officials have condemned Papandreou proposals with faint praise. The Dutch finance minister suggested that it was a nice first step but not sufficient and that more substantive measures are needed.

Others claimed it relied too much on one-off measures, like asset sales, a public-sector hiring freeze and wage cap for some civil service workers. Even Moody's, which seems to be genetically predisposed to optimism said that while the proposals were "relatively well designed", it would keep its negative outlook for the sovereign credit rating. The results of the EU's formal assessment are expected in early February.

The market is not waiting for the EU. It smells blood. Even if Greece's economic forecasts were credible, which they are not, it is inconceivable that Greece will achieve its stated objectives. The combination of tax increases and spending cuts that would be necessary is simply not politically or socially acceptable.



Source: IMF, 2009

Papandreou proposes cutting spending and raising revenue by €10 billion, nearly 4% of GDP, this year which would reduce the deficit to roughly 8.7% of GDP. This will exacerbate the recession from which Greece has yet to emerge. Leaving aside the public outcry, the deeper and more prolonged economic contraction will boost some counter-cyclical spending and in turn offset some of the fiscal consolidation. As counter-intuitive as it may seem, addressing the structural deficit could very well exacerbate the cyclical shortfall.

Moreover, Greece needs to raise around €53 billion this year, a quarter of which (€13 billion) is simply to service the debt, i.e. interest payments. This month, some debt was placed privately, without an auction, and this could, at least in part, be repeated next month.

However, the real crunch comes in the second quarter when the government projects bond maturities of some €16 billion and the intention of raising around €26 billion. Greece is exploring tapping the global capital markets with dollar and perhaps other foreign currency issues. And of course Greece is not the only country that will be issuing bonds. In fact the competition is rather fierce.

Return of the Repressed

Greece's woes are to a large extent of its own making. With an economy among the smallest in the euro zone at roughly 1/10 of Germany's, it needn't trigger a crisis. However, it is exposed a fatal flaw at the heart of EMU: monetary union without political union.

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791

Theoretically, the Stability and Growth Pact, which requires members to limit budget deficits to 3% of GDP, barring extenuating circumstances, could fill the void. However, the members have been reluctant to enforce the agreement and moreover, fining a country for an excessive deficit seems counter-productive insofar as it increases deficit/debt. Essentially the euro zone does not have the mechanisms to enforce the fiscal agreement.

It is precisely the incompleteness of European unification that allows some critics to argue that EMU is simply another fixed exchange mechanism. Unlike other countries that have currency pegs, like Hong Kong or Saudi Arabia, euro zone members have jettisoned national currencies. Greece has abandoned the drachma.

Europe could have chosen to keep national currencies but instead adopted a common currency as a way to signal its irrevocable commitment to monetary union. This means that the competitiveness Greece has lost over the last decade due to persistently higher inflation and labor costs, which some economists estimate to be around 30% against Germany over the past decade or so, cannot be recouped with devaluation.

With monetary sovereignty surrendered, members, and not limited to Greece, found the creative use of fiscal policy as a politically expedient way to disguise the loss of competitiveness. The incompleteness of European unification allows the evasion of the structural problems. The global financial crisis and the policy response, the euro's persistent strength, which has been one of the strongest currencies in inflation adjusted terms since its advent in 1999, and the ineptitude of Greece's political elite are finally forcing a painful confrontation of precisely these challenges.

Now What?

Many European officials and economists warn that for Greece to be bailed out would create a moral hazard writ large. Some express concern that a bailout of Greece would undermine the credibility of EMU, but letting Greece hang, even if by its own petard, also poses significant risks.

First, in the post-Lehman era, policy makers must be aware of various channels of contagion. If Greece is allowed to default, which under some political calculus may be less painful than structural reforms, interest rates throughout the region will likely rise sharply. It risks exacerbating the economic downturns and could even reignite an acute financial crisis.

It is not just the periphery of the euro zone, like Portugal and Spain, which could become tarred with the same brush as Greece, but some core members could be at risk. Belgium's debt to GDP is around 90% (the Stability and Growth Pact limits it to 60%) and alongside Austria, has banks most exposed to the fragile eastern and central European countries.

Greece's political elite remain committed to EMU. The cost of unceremonious unilateral exit would not necessarily solve Greece's problems and could very well risk a sharper economic downturn, even if it recoups some competitiveness, which in turn may be quickly eroded by inflation, high interest rates and a fiscal policy that still needs to be brought under control. Even if the other members wanted to, there does not seem to be a mechanism by which they can eject Greece from the monetary union.

It may take European officials a little while to truly appreciate their dilemma: that they are damned if they do and damned if they don't. But they do not have much time. By mid-year, the challenges Greece will encounter placing its debt could lead to a downgrade and the reason this downgrade is so important is that it would mean that next year the ECB will not accept Greece's sovereign bonds as collateral for its monetary operations. Needless to say this could spark a banking crisis that might make the 2007-2009 crisis seem like a tea party.

If a European institution, like the EU, ECB, ERBD, or some coalition of the willing countries cannot find a way to lend Greece funds, the IMF has demonstrated its ability to step into the breach. Various concessions from Greece would be demanded. These could include an erosion of sovereignty in terms of budget issues. Fiscal stimulus would be verboten. Its statistics office may be manned by non-Greek professionals. There may be scope for political concessions too in terms of Cyprus and Greece's refusal to allow Macedonia to join the EU and NATO.

The euro zone cannot evade its structural problem anymore than Greece can. To avoid the moral hazard problem, pro-active measures have to be taken. Even if a small horse has left the barn, it is not too late to bar the door and prevent future end runs. New institutional mechanisms are needed. The union needs to broaden to include fiscal policy and this appears to require the completion of the historic ambition of the political unification of Europe.

Marc Chandler
Global Head of Currency Strategy

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791