



Perspectives by Ruth Lea

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Greece's possible bailout: a painful precedent

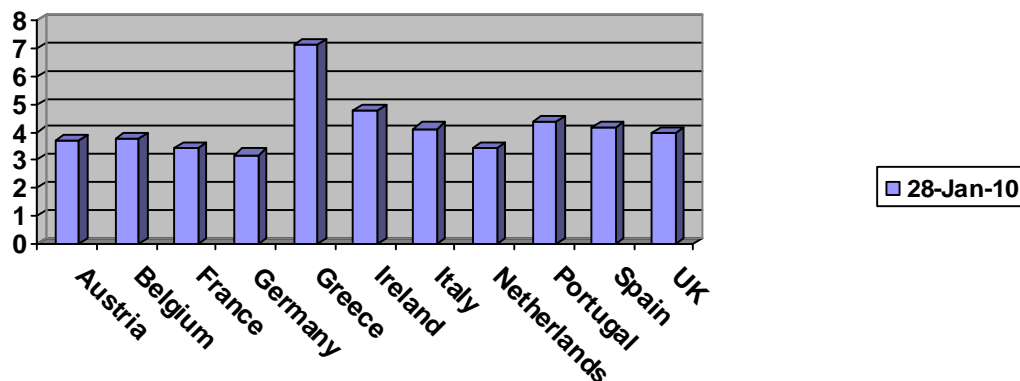
Introduction

In the last Perspective we discussed how the eurozone economies were diverging. Specifically we discussed the divergence between the peripheral “Club Med” countries – Greece, Spain, Portugal, and possibly Ireland and Italy – and the core economies centring on Germany, France and the Benelux countries. We concluded that the peripheral countries were currently in a policy trap and the consequences would be painful however they tried to release themselves from this trap.¹

Greece's fiscal crisis

Greece's intensifying fiscal crisis is focusing minds on just how painful this could prove to be. Greece's 10-year bond yields leapt to 7.2% on 28 January, around 4% higher than German yields, as market concern over possible default increased. (Yields eased to a shade under 7% on 29 January.) The spread with German bond yields was the widest since Greece joined the eurozone in 2001. Yet last week began with the successful sale of €8bn of Greek government bonds, but rumours that the government had approached China for help in financing its debt contributed to the collapse mid-week. The fact that Greece must raise €54bn this year, over half in the 2nd quarter, or risk defaulting, is more generally bearing down on sentiment.²

Yield on 10-year benchmark bonds (%), selected EU countries, 28 January 2010



Source: *Financial Times*, 29 January 2010.

The fiscal crisis has been building up since October 2009, when the newly-elected socialist government announced that public borrowing as a % of GDP was expected to be around 12.7% in 2009 – about twice that previously “estimated”. Manipulation of the data was suspected. Suffice to say that this was not the first time the Greek statistical authorities had been “economical with the truth” concerning their public finances data. The data were fudged ahead of euro entry.

As a response to the deficit the Greek Government announced a 3-year stability plan in early January to cut borrowing as a % of GDP to less than 9% in 2010 and to less than 3% in 2012. Policies included boosting tax revenues, containing public sector spending rises, curbing public sector hiring and cracking down on tax evasion. The plan was met with widespread market scepticism. The Greek Government now clearly has a “credibility deficit” to add to its parlous economic difficulties and its fiscal crisis. In the words of Greek Prime Minister George Papandreou “our biggest deficit is our credibility deficit” – as if the fiscal deficit were not big enough.

Market scepticism is understandable. Not merely will the Greek plans prove politically, economically and socially very challenging - public sector workers and communist trade unions are already planning anti-government protests for 10-11 February – the projections look untenable. The Commission is set to issue its opinion on the Greek stability plan on 3 February and the EU finance ministers on 16 February.

The EU's response

The Commission is, of course, extremely concerned about the possibility of Greece defaulting on its debt not least of all because of possible negative contagion to other vulnerable eurozone countries - Spain, Portugal and to a lesser extent Ireland and Italy. Above all else it does not intend to allow Greece's debt crisis to jeopardise the viability of the eurozone.

The Commission has now signalled that it will provide Greece with emergency support to prevent it from defaulting on its debt as a last resort.³ Both eurozone governments and the Commission would be involved in the operation. Under these circumstances it would, of course, closely scrutinise Greece's budget plans and relevant statistics.

Such support would go against the objectives of the Maastricht treaty's “no bail-out” clause which was intended to neutralise the moral hazard implications of allowing bailouts. It would also go against Maastricht's conditions for financial assistance which explicitly state that countries are only eligible for support when they are “in difficulties or seriously threatened with severe difficulties [which are] caused by exceptional occurrences beyond its control.” Greece's problems are home-made. Its blatant flouting of the remaining feeble strictures of the Stability and Growth Pact has been commented on many times and demonstrates all too graphically the need for far more discipline within the eurozone if it is to work more effectively as a currency union in future. Membership of the euro has effectively been without enforceable rules and weak economies have been allowed to run structural deficits at absurdly low cost. The relevant Articles of the Maastricht treaty are quoted in the annex.

The Commission would, according to recently leaked documents, expect Athens to impose very tough targets on its public finances if it were to provide support – possibly tougher than the Greek government’s proposals of early January. The documents, apparently entitled “Urgent measures to be taken by 15 May 2010”, give Athens a 4-month deadline to impose a stringent regime of budget cuts and financial reforms.⁴ The Commission demands that Greece should “...cut average nominal wages, including in central government, local governments, state agencies and other public institutions”. It also suggests new taxes on luxury goods and proposals to speed up tax payments by the self-employed. Greece, therefore, is expected to bear much of the responsibility for digging itself out of its crisis.

Unlike the 2008 aid packages to Hungary and Latvia, the IMF would not be involved. The IMF often ties aid to monetary policy, and the eurozone governments do not want to compromise the ECB’s independence.

Greece’s choices

Greece has, very broadly, two very unpalatable choices. The first is to impose big structural fiscal tightening, all too likely to lead to a deep recession and possible social unrest, as the price for staying within the eurozone.

The second would be to leave the eurozone, creating a new drachma and gaining a competitive lift from a depreciating currency. Politically this would be the absolute last resort. Few Greeks would want to leave the euro not least of all because it is a symbol of economic and political modernity. Moreover, Greek holders of euro debts could struggle to finance them as their currency depreciated. However, much of the benefit that Greece has experienced in recent years from quasi-German bond yields and relatively low borrowing costs has already been dissipated.

The peripheral eurozone: general comments

As we have already indicated, Greece is not alone in its fiscal difficulties. Spain, Portugal and Ireland are all running very large public sector deficits and suffering from competitiveness problems. (Italy’s position is somewhat different as its deficit is reasonably contained even though its debt to GDP ratio is very high.) Ireland introduced a tough budget in December and Portugal and Spain have recently announced budgets intended to cut deficits. Portugal’s budget, announced last week, did little to allay fears about its commitment to deficit reduction. The ratings agencies gave it a lukewarm response. Spain’s austerity plan, also announced last week, includes measures to narrow the budget deficit by €50bn over 4 years and increase the retirement age from 2013.⁵

As with Greece, Spain, Portugal and Ireland are imposing fiscal tightening when their economies are weak. Spain’s unemployment rate is 20%. This is their price for euro membership. A comparison of the countries’ individual budget plans is shown in the table below.

The peripheral eurozone members: comparison of budget plans

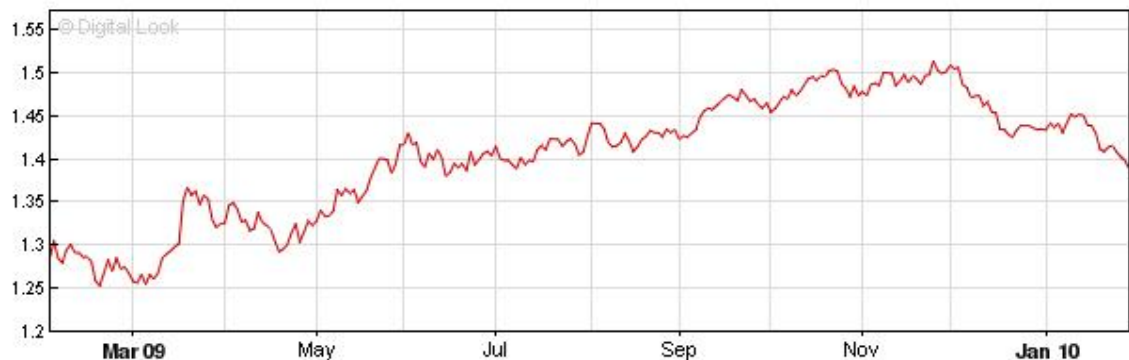
	Ireland	Portugal	Spain	Greece
Projected deficit, 2010, % of GDP	11.7%	8.3%	10.0%	8.7%
Target date for reaching deficit below the EU's 3% threshold	2014	2013	2013	2012
Budget announcement	December 2009	January 2010	January 2010	January 2010
Measures	Cuts in public sector pay of up to 20%, reductions in child & unemployment benefit	Public sector wage freeze, increase in CGT, 50% tax on bankers' bonuses	Spending cuts, including reduction in civil service hirings, higher taxes	Boost tax revenues, contain public sector spending rises, curb public sector hiring, crack down on tax evasion

Source: *Financial Times*, 30 January 2010, modified.

Greece's fiscal crisis: undermining the euro

The Greek crisis has a small sliver lining for the struggling economies of the eurozone. The euro has recently depreciated against both the dollar and the pound. At the end of last week it was at a 6-month low against the dollar and a 5-month trough against the pound. Since early December it has depreciated over 6% against the dollar and since the first half of October it has fallen about 6% against the pound.

Euro-US dollar rate, end-January 2009 to end-January 2010



Pound sterling-Euro rate, end-January 2009 to end-January 2010



Source: BBC News website, 31 January 2010.

Where next for the eurozone?

If Greece is bailed out in order to prevent it defaulting on its debt, this can only be a holding operation. It will be a crisis response to a crisis situation. But where does the eurozone go then? Of course, the Commission and the eurozone's "core" countries will continue to insist that Greece and the other peripheral countries must reform and improve their competitiveness. The Commission (with Eurostat) will scrutinise member states' economic data more closely and enforceable, tougher fiscal rules must be adopted.

But the economic fissures within the eurozone will surely remain. After all, the euro was essentially a political project. It was part of the European Project for the "ever closer union of the peoples of Europe". This is why the departure of even one of the weaker countries from the eurozone would be seen as a blow. It would signal a reversal in the "inevitability" of "ever more integration". And because the euro was primarily a political exercise the economics were treated as secondary when it was launched. Of course there were eligibility criteria – but they were superficial and comprehensively neglected key structural differences between members. These structural differences will not disappear, however brave the political rhetoric.

At some point there will have to be a policy response to the fissures between the richer "core" and the poorer periphery. Fiscal tightening in the periphery over the next few years will exacerbate the divide. At some point the eurozone will surely have to grasp the nettle of a central fiscal authority which redistributes cash assistance from the stronger and richer countries to the weaker and poorer. There is, however, no appetite for this at present – especially in the stronger countries.

A central fiscal authority would be another step towards the full political union of the eurozone countries, which accords with historical precedent. It should be remembered that few monetary unions have survived without political union. In the meantime, the world economy is changing inexorably with the rise of China and other major emerging economies.⁶ Europe, obsessed with its internal politics, risks being left behind.

References

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2. Alistair Osborne, "Greece is the word that should strike fear into all those who love the euro", *Daily Telegraph*, 30 January 2010.
3. Tony Barber, "EU reluctantly plans Athens bail-out", *FT*, 29 January 2010.
4. Iain Dey, "Brussels' tough targets for Greek rescue", *Sunday Times*, 31 January 2010.
5. Victor Mallet, "Spain uses budget to flex fiscal muscles", *FT*, 30 January 2010.
6. Ruth Lea, "The changing global landscape: G20 comes of age", *Arbuthnot Banking Group Perspective*, 5 October 2009.

Annex: Treaty on European Union

Economic and Monetary Union: relevant Articles

Original Article 104b, section 1 (Article 125 of the Lisbon Treaty): the "no bailout clause".

The Community [Union] shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

Original Article 103a, section 2 includes (Article 122 of the Lisbon Treaty): conditions for financial assistance

Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, the Council may, acting unanimously on a proposal from the Commission, grant, under certain conditions, Community [Union] financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken.

Source: *Treaty on European Union* (The Maastricht treaty), 1992.

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