



Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

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Session 5: Adjustment in the Euroarea

Internal adjustment in the euro-zone

Greece and the vulnerability of the European Monetary Union

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The Asian financial crisis of 1997-98, and the financial crises in Russia and in Argentina, all happened in emerging-market economies. Little did we think that the next sovereign debt crisis would be in an advanced country, or even in Europe. These earlier crises taught us three crucial things. Understanding them is vital to dealing with the Greek crisis.

First, the Asian financial crisis showed that the way for a country to recover from a financial crisis is to devalue its currency – to a very large extent – and then to go for export-led growth. We learned this from Thailand, Korea, Malaysia and Indonesia. What looked like a tragedy in the late 1990s now looks like a remarkable set of recoveries, in hindsight. Greece, within the European Monetary Union cannot do this.

Second, we learned from the Asia crisis that an IMF rescue is *not* a bailout. The huge loans from the IMF, approaching US\$100 billion, meant that Korea, Thailand and Indonesia could repay Wall Street in 1997-98 when, all of a sudden, capital fled from Asia. But these loans were not gifts. In the end the IMF and other creditors were repaid by the crisis-affected countries and these countries then collected the money from their own taxpayers. The IMF simply made it possible to repay Wall Street bankers immediately, whilst the crisis-affected countries collected the money from their taxpayers gradually. The IMF does not possess any sovereign debt reconstruction mechanism – through which such debts of this kind could be written down,

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despite valiant attempts by Anne Krueger to establish one early this century. These attempts were – predictably – blocked by the US Treasury and by US financial markets. As a result the IMF did not bail these countries out. It simply acted as a debt collector for Wall Street.

Third, we learned from Asia that default and debt write-downs may be a bad idea after a financial crisis. A debt overhang poisons recovery, since the need to repay very large loans leads to tax increases and cuts in government services which delay a return to growth. But when recovery comes, foreign direct investment will assist, bringing new technology and access to foreign markets, and helping exports to grow rapidly again. It is good to avoid default to make this investment possible. Messy legal fights about debt write-downs make this difficult, and so impede the recovery process. Asia recovered rapidly without debt write-downs.

How can we apply these three lessons to thinking about Greece?

The huge bailout of Greece by the IMF and the European Union, led by Germany, means that Greece will not need to borrow again from private financial markets for three years. During this time, bankers and other financiers who lent to Greece will get their money back. The IMF, and even more importantly, European taxpayers, will end up holding European debt. And Greece will get a three year period to put its house in order. In due course Greece is meant to repay these official loans to the IMF, to Germany and to other EU countries.

Might this not work?

The reason this is unlikely to work is that an export-led recovery strategy, like that described above for Asia, is denied to Greece. Countries within EMU cannot devalue their currency. Even if there is a willingness to accept extreme austerity in Greece, the recovery process will be blocked by a lack of competitiveness. Severe cuts to public expenditure programs and increases in taxes are a central part of the rescue package. These cuts should be replaced by a growing export sector. But without a more competitive export position these cuts will, instead, drag Greek economic activity down with them. Standard and Poor's, the ratings agency, has estimated that Greece will not return to its 2009 level of nominal GDP until 2017.

As this happens, tax revenues will chase the economy downwards. Even if austerity is accepted, it is projected that the deficit will continue to be large for some years, causing the ratio of Greece's debt to gross domestic product to rise from 125 per cent to 140-150 per cent during the adjustment period. The Greek economy will end up crippled by its debt. Severe cuts will begin to look like look savage cuts – and pointless ones. Austerity will – it seems likely – be resisted politically. As we have seen this last week, a black hole of violence is a possible outcome. This is not the kind of circumstance in which strong polices can survive. The political will to soldier on may evaporate, and be replaced by a rise in anti-European, and anti-German sentiment.

Hence, it looks inevitable that recovery in Greece will require a very large write-down of Greece's debts. This means that the rescue package, negotiated last week, is not enough.

There are systemic implications of this situation. International investors will come to fear the same outcome in Spain and Portugal. Spain has the remnants of a collapsed housing boom, nearly twenty per cent unemployment, an uncompetitive economy and an unsustainably large

public sector deficit. A strategy of cuts, like that for Greece outlined above, will probably not work there either. And Spain has a much larger economy than that of Greece, so the difficulties there will be even more significant. Portugal is smaller, but has suffered from a lack of competitiveness and a fiscal problem since well before the financial crisis. Rising risk premiums for Spain and Portugal suggest that the Greek problem has already become systemic.

This Greek crisis has deep political implications for Europe and the world.

Wolfgang Münchau in the Financial Times on 3 May, argues that many now believe that EMU will break up, unless there is very much greater political and fiscal integration within Europe, to prevent the kind of fiscal laxity which has driven Greece to the edge of this financial precipice. Countries in difficulties will need to accept much greater intervention by the European Commission in the conduct of their economic policy. Those who live in federal countries, like the US, Australia, and Canada, recognise the inevitability of such 'federal intervention'. But the political obstacles to achieving this within Europe are very large.

This crisis reveals an even deeper difficulty, one which has been slow to reveal itself.

For all of the ten years since EMU was formed, Germany has determinedly cut its cost and wage levels. Within a common currency area other countries are unable to escape the effects of such a 'race to the bottom'. The more competitive Germany, which has resulted from this, has taken demand away from other countries within EMU – including not just Greece, Portugal and Spain, but also others such as Italy. German policymakers have, at the same time, insisted that German domestic demand be held down to make room for this foreign demand. This insistence has culminated in a constitutional provision, enacted last year, which will, within a few years, prevent Germany from running any budget deficit at all. Such a policy has led to a growing German surplus within Europe. It has also been accompanied by an insistence that the less competitive countries, beginning with Greece, cut their spending. The result is that demand, which is taken away from other countries by Germany, is not replaced. The German competitive drive is leading, via this route, to a too-low level of demand within Europe. A Europe of this kind, deprived of demand, will be unable to grow to its full potential and will carry the economic and political burden of higher levels of unemployment.

The European Union Project now faces not only a deep political challenge. It also faces a challenge to its fundamental economic principles.

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