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NEW BUSINESS

The Bond Vigilantes Who Left Greece in Ruins

G195

Now, Europe is under pressure to rescue the Greeks while keeping other EU members in line

By Peter Coy

The European Union's experiment with a single currency is deep in crisis because Europe failed to learn from the Greeks. Not today's Greeks—the ancient Greeks, specifically Odysseus, the hero of Homer's epic poem. Odysseus knew his limitations. Realizing he was vulnerable to temptation, he ordered his sailors to tie him to the mast of his ship. That way he could listen to the bewitching song of the Sirens without obeying their call to steer the ship onto the rocks.

Today's Sirens are the investors and traders of the global bond market, who lure nations into tapping abundant credit at low rates when times are good. If a nation borrows too much, those open-handed investors abruptly turn into vigilantes who punish the country by making new loans scarce and expensive. Greece has fallen into precisely that trap. It got low-interest loans by promising to behave responsibly and keep its budget deficit low. That gained it admission to the single-currency zone in 2001. But because Greece was never tied to the mast, it kept spending. Its debt is now about 125% of gross domestic product, more than double the supposed EU ceiling. Eventually, all that debt brought down the wrath of the bond-market vigilantes, who drove up yields by betting against Greek debt, precipitating what has become the worst mess for the euro since the single currency's launch on Jan. 1, 1999.

At this point, Greece and the European Union have no good choices left. It's hard to see how Greece can muddle through on its own. On Feb. 10, striking labor unions shut down schools, hospitals, and air travel in a challenge to Prime Minister George Papandreou's austerity plan, which is intended to win back investors' confidence. Yiannis Kelekis, 68, a retired construction worker who joined a demonstration in rainy Athens, complained: "The people that caused the crisis are now asking for others to make sacrifices."

Noting the range of opposition, investors have concluded that Greece needs outside assistance to avoid default. If the European Union refuses aid, the government could find itself unable to issue $26 billion worth of debt as scheduled this spring. A Greek default—still considered highly unlikely—might trigger a run on the debt of Portugal and Spain. Like Greece, they belong to the PIGS—a name coined to describe Portugal, Ireland (and sometimes Italy), Greece, and Spain as the financial weaklings of Europe. "If Greece were alone in this, then possibly they would have been kicked out of the euro zone," says Diego Iscaro, economist at IHS Global Insight in London. "But they can't do that, because Greece is not alone." Stephen L. Jen, portfolio manager of BlueGold Capital Management, a London-based hedge fund manager, says German banks' exposure to debt of the five PIGS equals 19% of German GDP.

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Trouble is, extending aid isn't a great choice, either. If the European Union helps Greece, then Portugal and Spain, whose finances are only slightly stronger, could demand similar help. That would stir resentment in the richer nations such as Germany and France. Worse, it would undercut the EU's

ILLUSTRATION BY DAVID RUDES/BW; PHOTOS BY LOUIE PSIHOYOS/SCIENCE FACTION/CORBIS; GREGOR SCHUSTER/CORBIS; AL RODRIGUEZ credibility as an enforcer of fiscal rigor.

As of Feb. 10, European officials seemed to be angling for a compromise plan to aid Greece but on such harsh terms that no one else would want such a deal. Germany and France were leading talks to help Greece under "tough preconditions," said Markus Ferber, a member of German Chancellor Angela Merkel's bloc in the European Parliament, citing discussions his group had with the federal officials in Berlin.

While Greece is uniquely dysfunctional, there's a lesson here for any country with a heavy debt load, including Britain, Japan, and the U.S.: The bond market is treacherous. For now, investors are pouring money into the U.S. Treasury market as a safe refuge. But the U.S.'s ratio of total debt to GDP is likely to exceed 90% this year, making it more indebted even than Spain and Portugal. If global investors began to demand higher yields to compensate them for the risk of a U.S. default, that would vastly increase U.S. borrowing costs. Higher debt service would worsen the nation's budget imbalance and possibly precipitate the very crisis that investors fear most. A long shot, to be sure, but not impossible.

Bond market speculators thrive in murky situations like this, where no one is ever quite sure what's true and what's a bluff. When Greece joined the euro zone, its borrowing costs fell to near-German levels because bond investors bought into the theory that Greece had finally become fiscally

An angry nation: Firefighters in Athens protest planned budget cuts ...

responsible. Lately, though, as Greece's fiscal weaknesses became clear, the profits have gone to those players who bet against Greek debt, shorting the bonds and talking up the bad news coming out of Athens. In the month through Feb. 10, the yield on the Greek government's three-month bills soared from less than 1% to 4%, raising the nation's borrowing costs.

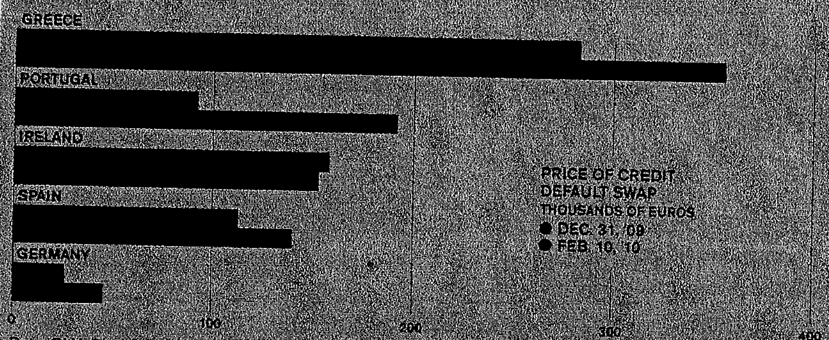
Modern Greeks haven't had an easy time living up to their ancestors, who gave the world democracy, drama, and philosophy. According to economists Kenneth S. Rogoff of Harvard University and Carmen M. Reinhart of the University of Maryland, Greece has been in default for half of the time since it won independence from the Ottoman Empire in 1829.

Protests and strikes occur frequently in Greece because they tend to be profitable. "Every time somebody had to be bought off, they were bought off very generously," says Yale University political scientist Stathis N. Kalyvas. Meanwhile, Greece, like other small members of the European Union, has received extensive assistance from EU coffers. "The lesson being learned was not only was there no price to pay for not disciplining yourself, but in fact there was a benefit," says Kalyvas.

Greece seemed to be getting its act together a decade ago, when it was one of the fastest-growing economies in the EU. It reined in spending, reduced inflation, and cut interest rates. And it surprised critics by putting on a successful Summer Olympics in 2004. That proved to be the high point. Just after the Olympics, Greece acknowledged that it had understated its budget deficits for 2000, 2001, and 2002, meaning its fiscal gap had regularly exceeded the European Union's criteria for euro zone membership.

DEFAULT INSURANCE GETS COSTLIER

Prices of credit default swaps on sovereign debt have risen this year, indicating investors' greater nervousness that national governments will default on their debts. The prices represent the annual cost of insuring for five years against the default of government bonds with a face value of 10 million euros.



Data: CMA DataVision, Bloomberg

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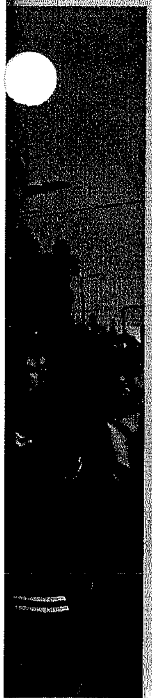

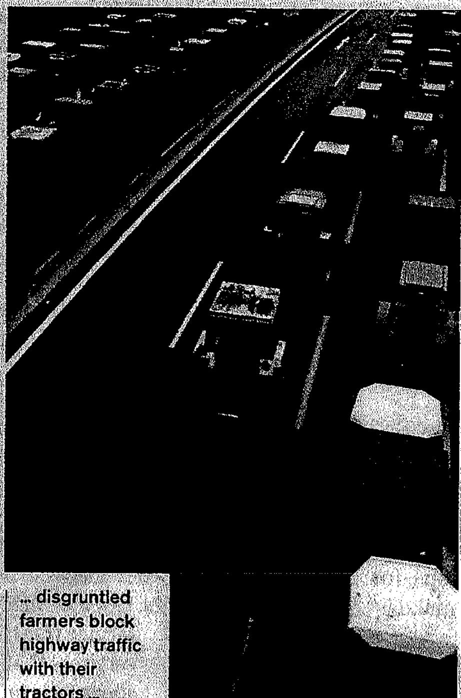

... disgruntled farmers block highway traffic with their tractors ...

... and Greeks march in central Athens during a public-sector strike

Deficits continued. Last October the newly elected socialist government announced that the deficit was far worse than the previous conservative government had let on. That led to downgrades by credit-rating agencies, sparking the current crisis.

For now, the Greek government is still saying it can muddle through on its own. Greek Finance Minister George Papaconstantinou told Bloomberg Television on Feb. 8 that "the worst possible signal which we could send out is one calling for outside help."

Some economists see hope. Despite the unions' opposition, recent polls by Greek newspapers showed solid majorities backing the socialist government's austerity plan of spending cuts and tax increases. The vicious reaction of the bond-market vigilantes apparently convinced many Greeks that continued overspending was the road to ruin, says economist Elias Papaioannou of Dartmouth College. "People now have truly digested how serious and alarming the situation is," says Papaioannou. Adds Panagis A. Vourloumis, chairman of the Greek phone company Hellenic Telecommunications Organization: "This crisis could be a be a blessing in disguise if the government can push through the reforms that have been overdue for the last 30 years."

Investors, though, are dubious. That's evident from trading in credit default swaps on Greek debt, which pay buyers the full face value of a bond in case of a default. On Feb. 10 the price of default insurance was 356,000 euros per year for five years of protection on 10 million euros worth of debt, down 16% from two days earlier but still almost quadruple the price of last summer. Investors are skeptical that Greece will meet its goal of slashing its budget deficit as a share of GDP from 12.7% in 2009 to under 3% in 2012.

Greece and the EU wouldn't be in this no-win situation if they had followed their own rules from the start. But coming up with a mechanism that forces sovereign nations to do what's right when they feel like cheating is pretty much impossible. The EU has the authority to fine Greece as much as 0.5% of GDP every year until its shortfall is back in line, but that would just make the deficit bigger.

Americans can relate to the European dilemma. Congress had a pay-as-you-go budgetary rule in effect from fiscal 1991 through fiscal 2002, but abandoned it in the name of flexibility in the aftermath of the 2001 recession.

Flexibility is great, most of the time. But as Greece vividly demonstrates, any country that doesn't discipline itself is bound to be disciplined eventually by the bond market. And that's a whole lot more painful. | BW |

–With Maria Petrakis, Natalie Weeks, Svenja O'Donnell, and David Tweed in Athens, Stanley Reed in London, and Carol Matlack in Paris

Business Exchange

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You Can't Have It All

Turmoil in the euro zone has reawakened interest in a theory put forth in 2007 by Harvard University economist Dani Rodrik. In a post on his blog, Rodrik argued that "democracy, national sovereignty, and global economic integration are mutually incompatible." It's possible to have any two but not all three, he wrote, calling this "the inescapable trilemma of the world economy."

To read the post, go to **http://bx.businessweek.com/global-economy/reference/**