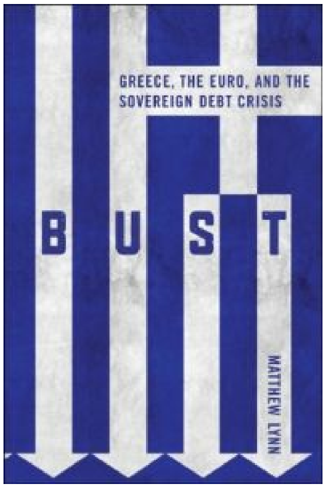

Book Bust

Greece, the Euro and the Sovereign Debt Crisis

Matthew Lynn
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Recommendation

For a relatively small country, Greece has made outsized contributions to the world: mythic legends and heroes, great art and architecture, illuminating philosophers and thinkers, and the very word "democracy." Yet the nation that invented the Greek tragedy is living its own version of one today, dealing with fatal flaws that threaten to spread its suffering to the rest of Europe and beyond. Journalist Matthew Lynn dissects the origins of Greece's debt crisis and relates how the dream of a united Europe has led to what he predicts is the euro's imminent downfall. His dry, witty, clever writing style provides some relief around the all-too-real events he recounts and the dramatic prospects he predicts. *BooksInShort* recommends this modern-day tale of unfolding human tragedy that's going to need a deus ex machina to bring catharsis and resolution.

Take-Aways

- Greece's 2010 economic collapse has its roots in the country's membership in the European Monetary Union (EMU) and the European Union (EU).
- Economic and political considerations drove the EU to create the euro in 1999.
- In its first decade, the euro seemed to integrate the EU's 329-million-person economy.
- The EMU first rejected Greece's application for inclusion in the eurozone, but thanks to gross accounting errors, it met the economic criteria for membership by 2001.
- Greece absorbed the surpluses of its northern neighbors to finance its spending.
- Tax evasion and outmoded state largesse are endemic to all parts of Greek society.
- Despite Greece's deception on entering the monetary union, the EU let Greece retain the euro as its currency.
- The "PIIGS" – Portugal, Italy, Ireland, Greece and Spain – ran up debts and deficits from the cheap money pouring into their apparently booming economies.
- Once the EU agreed to support Greece, the markets pounced on the euro.
- By buying up the bonds of its weaker members, the EU has become responsible for all its individual states.

Summary

United They Stood, Divided They Fell

In May 2010, thousands of Greeks took to the streets to protest the draconian austerity measures Greece's economic collapse had forced their massively indebted government to adopt. But the real cause of the Greek fall had its roots in the country's enthusiastic accession to the euro and European Monetary Union (EMU) a decade earlier.

> "The Greeks wanted in [to the euro]. The interesting question was always going to be whether the rest of Europe would let them join the club."

The idea of uniting the nations of Europe politically and financially dates back many years: Napoleon Bonaparte, Victor Hugo and Winston Churchill all advocated continental monetary union. Certainly, economic justification for creating a common currency existed; much of Europe's trade was intraregional, and unpredictable national currencies placed undue price risk on manufacturers and exporters. Politically, the need to prevent another major war like the ones that engulfed Europe during the 20th century presented a major impetus for union. The 1970s and 1980s saw a few attempts at economic coordination: The Snake and the European Monetary

System (EMS) were foreign exchange mechanisms that attempted to keep European currencies within predetermined trading values. But each format failed when individual governments were compelled to spend huge amounts of reserves maintaining their currencies' prescribed values.

The Euro

Politicians and economists gambled on the euro as the currency that – by replacing national monies – would act as a single force in exchange markets. While removing financial friction among the European participants, the euro would present the combined strength of a 329-million-person economy, backed by the European Central Bank (ECB). However, the national governments behind the euro would still maintain central banks, tax systems and sovereignty. To make the euro work, participant economies had to move in sync; one nation could not experience a recession while another expanded. Once they adopted the euro, states couldn't devalue if they borrowed too much. They had to keep labor costs down to keep their economies competitive. Markets had to perceive the euro as strong, stable and as potent as the German deutschmark, Europe's star currency. The EMU's Growth and Stability Pact set a maximum on nations' budget deficits: No member country could sustain deficits of more than 3% of gross domestic product (GDP). If a nation failed to rein in its spending or overborrowed, it could not count on its sister states to rescue it; the Maastricht Treaty that established the euro explicitly forbade bailouts. But in reality, the EMU's rulebook set no penalties for exceeding the deficit limit.

> "It wasn't just the Greeks who were burying their heads in the sand. We all were."

By the euro's 10th anniversary in 2009 (1999 saw the launch of the currency for financial transactions only; the euro debuted as legal tender in 2002), many lauded the monetary union's apparent success: New member countries had joined, trade had expanded and regional inflation was minimal. Unemployment was low. Economic union and globalization spurred 16 million new jobs. European banks and firms could borrow more easily across the continent, fueling economic growth. Commentators increasingly talked up the euro's potential to replace, or at least share, the US dollar's role as the world's reserve currency. Crucially, the euro's triumph underscored the real possibility that EMU nations could vault from economic cooperation to true political union.

The Black Sheep

Greece became a great beneficiary of the euro's success. The nation had looked to the euro to lift it from a long history of political infighting and stunted economic growth. Greece missed the post-World War II rebuilding boom. Two ruling families shared control for decades while stirring political dysfunction. A military junta usurped the government in 1967; by the early '70s, the economy was in shambles; only tourism and shipping provided income and foreign exchange. Once democracy took over again in 1973, the state began to nationalize public services and industries; by 1990, 45% of Greece's GDP was under state dominion. In contrast to free-market expansions in the UK and the US in the 1980s and 1990s, Greece "turned left at a time when everyone else was moving right." Wages rose, inflation reached 25% and trade deficits soared. The Greeks desperately needed the euro's imprimatur of discipline and stability.

> "The deception used to smuggle Greece into the euro had...been a significant one."

But the rest of Europe wasn't prepared to welcome Greece with open arms. Germany, in particular, hesitated to allow an economy as distorted as Greece's into a currency union. Thrifty Germany feared Greece's excesses would drain resources from northern states, whose economies were flourishing from decades of disciplined growth. Greek government spending was huge; during the '90s and into the 2000s, public debt soared to 102% of GDP. And Greece lagged behind its European partners in many other measures, such as research and development, innovation, computerization and skilled industries. If Greece wanted to live in the euro's respectable embrace, it would have to exercise financial discipline, cut spending, make its labor force competitive and develop industries that could produce what the rest of the region would buy, at competitive prices. And it would need to get its budget deficit down to 3%, a seemingly impossible feat, considering Greece's deficit had reached 16%. So in 1999, while the EMU permitted Italy, Spain and Portugal to join the euro, it shut the door on Greece.

Magic Numbers

But neither the Greek government nor the EU would take the bad news lying down. For the EU, the euro's credibility rested in having as many initial members as possible; leaving Greece out would have left a hole in the euro fabric. For Greece, reversing its horrible statistics and gaining euro membership became a matter of national pride. In the course of 2000, "something very mysterious – and indeed convenient – happened. The Greek economy completely transformed itself. Just like that." In less than two years, Greece's budget deficit plummeted to only 1% of GDP, and inflation fell to 5%. Government debt, though still high, slowed its rapid growth. Greece met the EMU entry criteria and, in July 2000, became a full EMU member. From that moment on, global investors no longer distinguished between Greek risk and EU risk; it was all the same. Greece became part of the "richer men's club," with the same interest rates, credit assessment and investor interest as its European neighbors, "as if Sicily could morph into Switzerland over night."

> "The notion of a single currency, like all bad ideas, has been around for a very long time."

Greece quickly became investors' destination of choice, and money flowed into the country. Wages grew while worker productivity stalled. Still, government output exceeded income because tax evasion is widespread in Greece. Estimates say that cheating on taxes is common among 98% of middle-class Greeks, resulting in a yearly shortfall of $30 billion. Egregious tax avoidance, along with outmoded state largesse, is endemic to all parts of society. For example:

- Swimming pool permits cost €5,000 a year, but tax returns indicated pool ownership for only 324 households in a wealthy Athenian suburb. A simple Google map view showed that, in reality, the area had 16,974 swimming pools.
- Physicians routinely claim minimal amounts of taxable income, and some never issue receipts for any patient visits.
- The average Greek retires at age 58 and collects 96% of his or her preretirement income, double the percentage a German retiree earns. In addition, the Greek government classifies many jobs as "arduous." Because their work falls under this category, hairdressers, car washers and radio technicians qualify for early retirement.
- For as long as they remain single, the unmarried daughters of deceased Greek civil servants continue to receive government pensions. Female state workers can retire early if they have children under the age of 18.
- In 2008, Greek railroad workers' wages totaled more than four times the rail system's revenues from tickets sales. "According to one calculation, it would have been cheaper...to pay for the passengers to all get taxis" than to keep the rails running.

> “Arrogance and hubris had caught out a generation of political leaders that had pushed too hard and too fast for political and monetary union.”

But in September 2004, Greece’s game was up: Prodded by an EU study, the Greek finance minister agreed that “significant accounting errors” plagued Greece’s euro admission. In fact, Greece’s actual economic performance in the period leading up to the nation’s euro accession did not meet EMU standards, so Greece never should have been included in the euro. But, because no real penalties existed for Greece’s deception, the EU let Greece remain in the currency union.

The “PIIGS” at “Club Med”

Throughout the first decade of the 21st century, economic progress in the EU as a whole solidified the euro’s performance. But on closer inspection, some countries did not contribute to the group’s success. The single currency created an economic imbalance. The economies of the north – Germany, the Netherlands, France and Belgium – grew gradually and generated surpluses; Portugal, Italy, Greece and Spain – named the Club Med countries for their borders along the Mediterranean Sea – ran up debts and deficits from the cheap money pouring into their apparently booming economies. Along with Ireland, these nations (the PIIGS) essentially took in more than their output, while their northern neighbors produced more than they consumed. Banks in the “core of Europe” lent this surplus to the Club Med countries, encouraging their deficits.

> “The euro was meant to be a device for drawing the nations of Europe together...Instead it was driving them further and further apart.”

As the EU’s largest economy, Germany contributed the most while receiving less in exchange. The nation’s economic and political history left Germany with strong fiscal discipline and a fear of inflation, so the total debt incurred by its government, citizens and companies grew only 7% from 2000 to 2008, while debt rose 157% in the UK and 70% in the US. Germany paid the EU’s bills, an unfair deal its people began to question when the 2008 global financial panic hit.

Spreading Crisis

As recession spread, European countries responded like other developed nations – by infusing their economies with huge amounts of money. The ECB lent European banks funds at 1%, while the banks profited by lending to the Greek government at 4%. This gave Greece’s creditors “a false sense of security” that the EU stood behind Greek debt. But in December 2009, Standard & Poor’s rating agency gave Greece a negative review, followed quickly by downgrades from other rating agencies. Investors woke up, Greek debt interest rates rose and the nation’s banks came under pressure. Greece’s problems compounded when markets learned that Goldman Sachs had used derivatives to mask the extent of Greece’s borrowing. By then, Greece had a 13.6% deficit.

> “The euro could have been saved even as late as May 2010. How? By letting Greece go bust.”

Bond markets awaited the comfort of an EU declaration of support for the flailing Greek economy, but none was forthcoming. Greece’s sister states hesitated, not only because of the Maastricht Treaty’s explicit ban on bailouts but also in fear of the moral hazard that would result from rescuing the profligate Greeks: Disastrous “contagion” could affect the PIIGS. Germany in particular held out, its media stirring citizens’ opposition. One headline, “Sell your islands, you bankrupt Greeks! And sell the Acropolis, too!” summed up German popular opinion. The Greek government set drastic austerity measures, which brought thousands of Greeks out to protest. Greece resorted to its only leverage: embarrass the EU by admitting that a member needed rescuing by the International Monetary Fund (IMF), the world’s financial emergency squad. Yet the Greeks miscalculated. German Chancellor Angela Merkel felt that IMF expertise would be useful in sorting out Greece’s fiscal mess and in compelling the country to accept sacrifices the nation should have been making all along. On April 11, 2010, the EU announced an emergency package combining EU funds with IMF aid, but spending €45 billion to tackle Greece’s total €300 billion debt was clearly inadequate; the markets pounced on the euro.

The End of the Euro?

By disregarding its own bailout prohibition, the EU turned the euro from “a hard currency to a soft one.” European economic leaders scrambled over a “trillion dollar weekend” in May 2010 to hash out a united defense of the euro that obligated even nations that had opted out of the currency. In essence, the EU bought up the bonds of its weaker, at-risk members. In doing so, the EU became responsible for all its states, a stance that had been anathema to the founders. Ironically, European nations found themselves inching closer to political union, but not in the way they may have wished. This near-death experience uncovered the flaws inherent in the euro and the union it proposed: 1) Economic health must precede political will. Combining economies as disparate as Germany’s and Greece’s was a recipe for financial disaster; 2) Markets should rule, and Greece should have failed – or the EU should have let Greece fail – in order to save the euro; and 3) The “utopian scheme” that led to the euro did not build in any “room for error.”

About the Author

Matthew Lynn is a financial journalist and columnist for Bloomberg TV and Bloomberg News. He wrote the Death Force military thriller series.
