“Lehman Brothers Squared”

By John M. Berry

What’s at stake with Greece.

In the aftermath of World War I, the victorious, vindictive allies gathered for a peace conference at the Versailles Palace outside Paris. There, they realigned many international boundaries and imposed reparations on a defeated Germany that were far in excess of that country’s ability to pay. Now, in a sense, the shoe is on the other foot.

Germany, not as the victor in a war but with power gained from being by far the strongest economy in Europe, is demanding that a profligate Greece repay debts owed largely to other nations in the European Union that the Greeks cannot pay without further beggaring themselves. An attempt to do so, in the view of some observers, could lead to a truly radicalized political result.

As Martin Wolf, the renowned columnist for the *Financial Times,* wrote recently, “What cannot be paid will not be paid.”

What is ultimately at stake for Europe is far more than the future of the battered Greek economy. The new Greek Prime Minister Alexis Tsipras and his leftist Syriza Party won control with campaign promises to relieve the onerous austerity imposed on the country by lenders—a troika comprising other EU countries led by Germany, the European Central Bank, and the International Monetary Fund. German Chancellor Angela Merkel and numerous other German officials reacted to Syriza’s victory with shrugs. The Greeks owe the money and must repay it, they declared.

Yanis Varoufakis, the new Greek finance minister, prepared a statement before meeting with his German counterpart, Wolfgang Schäuble, in which he recalled the economic chaos in Germany that followed World War I and helped bring the Nazi party to power. “I think that the German nation is the one nation in Europe that can understand us better than anyone else,” Varoufakis declared. Schäuble gave no sign he regards that history as relevant.

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Later, the new government's foreign minister proposed that Germany pay further reparations for the immense damage Greece suffered during World War II. That was immediately rejected by German authorities. And the new Greek defense minister said that if European countries would not continue to finance Greek debts, some other source of funds might found, perhaps the United States, China, or maybe Russia. Certainly Russia, already suffering from a recession and a severe outflow of hard currency as a result of plunging oil prices, is in no position to help.

In mid-February, negotiations between Greece and the current lenders appeared to be at an impasse: EU representatives were demanding that the current program be extended without change, while Varoufakis argued that the program must be replaced with one that will allow the deeply depressed Greek economy to grow again. The only alternative to an agreement is for Greece to leave the eurozone. Most Greeks, including Tsipras, clearly don't want that to happen. It might be devastating for Greece, perhaps with its banks failing. That outcome could also badly damage other weakened members of the union as investors speculate about which other country might also be forced to drop the common currency.

Barry Eichengreen, an economic historian at the University of California at Berkeley, said at the annual meeting of the American Economic Association in January that a Greek exit would generate massive financial turmoil. "In the short run, it would be Lehman Brothers squared," he said. Given that prospect, he expects compromises will be reached. "While holding the eurozone together will be costly and difficult and painful for the politicians, breaking it up will be even more costly and more difficult."

The program agreed to by the lenders and the previous Greek government in 2010 and modified in 2012 calls for more stringent budget measures that have sharply lowered Greeks' standards of living. In the election, Greek voters effectively said enough is enough. In mid-February, Tsipras easily got legislative approval to scrap many of the features required by the bailout, with polls showing that three-quarters of the public supported the action.

Even in a depression—and that is the right word for the current state of the Greek economy—most people are still working, the Athens subways run as scheduled, and downtown bars and popular restaurants are full on weekends. But there are also beggars on the streets and many homes are without electricity or water because of unpaid bills. The health care system is a shambles with some hospitals unable to provide trained nurses.

A Greek exit would generate massive financial turmoil.

Greece's new finance minister, **Yanis Varoufakis,** *described the current agreement with the troika as "fiscal waterboarding."*

Consider these appalling official Eurostat numbers:

- **Unemployment:** The highest in the European Union, 25.8 percent last November. For workers under twenty-five, joblessness averaged 58.3 percent in 2013. And roughly half of the unemployed have been out of work for more than a year.
- **GDP:** Between 2008 and 2013, it contracted 26 percent as the standard of living plummeted.
- **GDP per capita:** In 2008 it was 93 percent of the EU average, and five years later it was down to only 73 percent of that average. That huge 20 percentage point decline is far worse than in other financially troubled EU countries, such as Spain, which was down 8 percentage points to 94 percent of the EU average; Italy was down 7 percentage points to 99 percent; and Portugal was unchanged at 79 percent over the same period.
- **Employee compensation:** In 2013 it was €59.3 billion, down 28 percent from €82.4 billion in 2008. Lower wages have made Greece more competitive internationally but at a time when low growth in many parts of the world has reduced demand for imports.
- **Gross fixed capital formation:** It was €20.5 billion in 2013, almost two-thirds lower than in 2008. The country's stock of productive capital has been stunted, another barrier to any economic revival.
- **Gross government debt:** It reached 175 percent of GDP in 2013 because debt had risen and the economy had collapsed.

A key reason the economy is in such dire straits is that, as required by the bailout deal, the government has slashed spending and raised taxes significantly. The highly restrictive fiscal policy has hammered both consumption and investment. In fact, according to estimates from the Organization for Economic and Cooperation and Development, the Greek budget is by a wide margin the most restrictive among all industrial nations. The country's so-called cyclically corrected primary balance—that is the balance between revenues and spending other than for interest payments on debt—is around 7.5 percent of GDP. Even without the adjustment for the severe economic slump, the primary balance is close to 2 percent of GDP. Moreover, under the current plan, fiscal policy is supposed to become even more restrictive, with the primary surplus rising to 4.5 percent of GDP next year and beyond.

Reza Moghadam, vice chairman of global capital markets at Morgan Stanley who as former head of the IMF European department helped craft the plan, said last month that sticking to it "would threaten social cohesion and wreck any prospect of economic recovery. Politically, it is out of reach. Meanwhile, the debt overhang is holding back investment and public confidence."

In a column in the *Financial Times,* Moghadam said phased-in debt relief, with conditions requiring continued governmental reforms, could bring down that debt overhang. Keeping the primary budget surplus about where it is could "make the government finances sustainable," he said. "As an incentive to reform, most proceeds could be allocated to social spending," he added.

An IMF report on the Greek program in May 2013 said there were both notable successes and failures as a result of the 2010 plan. Successes included a "strong fiscal consolidation," the pension system put on a viable footing, and Greece remaining in the eurozone. As for failures, market confidence was not restored, banks lost nearly a third of their deposits, and "the economy encountered a much-deeper-than-expected recession with exceptionally high unemployment, among other things."

Another important failure was that the plan overestimated what the IMF calls "ownership" of economic adjustment programs such as that in Greece. "Ownership" is about the extent to which political leaders in a country are willing to accept and execute the changes called for in a program. That continues to be a concern. Ironically, some observers say that Tsipras, distinctly an outsider politically, may be more willing than his predecessors to execute some of the needed governmental reforms, such as further reducing public payrolls.

The failure of the troika program to revive market confidence should have given Merkel and her conservative supporters pause. They have maintained for years that austerity, particularly cuts in government spending, not just in Greece but everywhere, will spur economic growth by increasing confidence among investors and private businesses. Unfortunately, that phenomenon—which economist Paul Krugman, the *New York Times* columnist, has labeled "the confidence fairy"—didn't appear in Greece or anywhere else, including in the United States where conservative members of Congress successfully demanded spending cuts using much the same arguments. Merkel is so convinced that she is right, actual results seem to make no difference.

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As for the election results and conditions in Greece, Hans-Peter Friedrich, a prominent Merkel supporter, told *Bild,* the German magazine, "The Greeks have the right to elect whomever they want; we have the right to no longer finance Greek debt. The Greeks must now pay the consequences and cannot saddle German taxpayers with them."

Actually, the Greeks can do exactly that if they decide to default on the debt. Back in 2010 when the extent of Greece's debt problems became public, Germany and other countries in the eurozone headed off a default in part to keep from having their own banks struck by possibly crippling losses on Greek sovereign debt they held. To finance the assistance required, the countries created the private, Luxembourg-based European Financial Stability Facility, or EFSF. It was capitalized by the issuance of about €180 billion worth of bonds guaranteed by all the EU governments. With the guarantees, the bonds were rated triple-A. With the cash, the EFSF bought up bonds issued by Greece, Ireland, and Portugal. Ireland and Portugal paper has since been redeemed, but the facility still holds €141 billion worth of Greek bonds.

Economist Carl B. Weinberg of High Frequency Economics in Valhalla, New York, explained to his clients back in December, "The price of that [Greek] paper could drop severely and suddenly if Greece were to fail to service its obligations, unless the EU governments step up with hard cash—not just promises—to ensure that the guarantees are delivered. In this way, Greece's woes could become the woes of all the institutions that bought EFSF paper as 'safe' assets, some of which are banks and various other financial institutions."

"Germany's contribution to recapitalize EFSF to reserve against a €141 billion Greek default would be €38.3 billion," Weinberg said. And in that way, part of Greece's debt burden would be shifted to German taxpayers whether they liked it or not, with smaller impacts on other EU countries.

The key issue is whether this debt imbroglio can be resolved with Greece retaining the euro as its currency. Its exit

could, among other things, spur a run on its banks, which are already separately borrowing heavily from the ECB to maintain their liquidity. Should the Greek banks not be able to repay the liquidity loans, the losses would not be shared among all the eurozone countries but would fall on the Greek central bank alone and thus on the Greek government. Meanwhile, the ECB decided that the banks' ability to repay the liquidity loans was so uncertain that they will have to pay a higher interest rate on them.

The ECB underscored that risk when it released details of its new quantitative easing program, to begin in March, as part of an effort to spur economic growth and increase inflation. Eurozone inflation is barely above zero, far below the ECB's close-to-2 percent target. Similar to what the Federal Reserve did in the United States, the ECB will buy mostly sovereign bonds issued by all the national central banks plus a much smaller amount of other bonds issued by institutions jointly backed by all the governments, such as the EFSF. Losses on the latter would be shared among the countries. Losses on sovereign bonds, such as those issued by Greece, would not be shared.

In their Money, Banking and Financial Markets blog, well-known economists Stephen Cecchetti and Kermit L. Schoenholtz criticized the ECB decision on risk sharing. "From our perspective, the problem is that capping risk-sharing is a major step away from a seamless pan-European financial market and toward the renationalization of monetary policy. Our prime concern is that depositors and investors will view the refusal on the part of European governments to mutualize sovereign risk (which is what this is) as a refusal to share financial system risk as well."

It may well be that this step away from the full risk sharing that is implicit in the euro monetary union was taken to appease German objections by Merkel and others in her government to having any quantitative easing at all.

During the Greek election campaign, Tsipras, the new prime minister, took a tough line regarding the debt, suggesting he might repudiate it if elected. He has since toned down his rhetoric and so to a degree has the finance minister, Varoufakis, an economist with a Ph.D. from the University of Essex in Britain who has taught at several universities. In an interview with the *New York Times* in late January, he described the current agreement with the troika as "fiscal waterboarding, where we are constantly having our head held under water." But he said his government wants to negotiate with the creditors, not confront them.

"All we are asking for is an opportunity to put together a proposal that will minimize the costs of Greece's loan agreement and give this country a chance to breathe again after policies that created massive social depravity," Varoufakis said.

That negotiation needs to come quickly. The next planned disbursal of €7 billion in troika money is due at the end of February, but Varoufakis has said he doesn't want that money. "We want to sit down and rethink the whole program." He wants that rethink to include allowing Greece to keep its primary budget surplus at between 1 percent and 1.5 percent of GDP, rather than squeezing the country and the economy to raise the surplus to the current goal of 4.5 percent or more and keep it there for several years.

A few days later, Dutch Finance Minister Jeroen Dijsselbloem, who is also head of the Board of Governors of the European Stability Mechanism, met with Varoufakis. Afterward, Dijsselbloem rejected his call for a conference to discuss reducing Greek obligations or debt relief. Germany's finance minister, Schäuble, said he and his government were willing to talk but would not be pressured by Syriza. "We are averse to blackmail," Schäuble said.

Some of this back and forth is pre-negotiation posturing. Still, it is ominous. The Germans, with particularly strong support from the Dutch and the Finns, seem adamant that Greece must continue to increase its primary surplus and use that revenue to pay down its debt.

So what leverage do the lenders have? Primarily the money that the ECB has advanced Greek banks. Without it, the banking system likely would collapse, and at that point Greece would have no choice but to exit the euro. Would ECB President Mario Draghi conceivably do that to Greek banks? Remember that before deciding to launch quantitative easing, he pledged to do "whatever it takes" to protect the euro. Ending those loans to Greek banks might destroy it. Nevertheless, the latest ECB actions have so limited the use of Greek bonds, even Treasury bills, that they cannot be used as collateral for loans from the ECB.

Without some relief for the Greek people, Tsipras and Varoufakis might decide that the financial turmoil that could follow an exit would not be worse than continuing to ratchet up the budget surplus and further squeeze the depression-wracked economy. For the rest of Europe, the choice seems clear: grant substantial relief in the form of a major restructuring for Greek debt, or risk a potential breakup of the eurozone. ◆

The highly restrictive fiscal policy has hammered both consumption and investment.