

A Greek Tragedy or a European Farce? Time to Re-Write the Script

Andrew Watt on 18.02.2010

In the official account of the unfolding Greek tragedy the villain is readily identified, the plot is clear, and the dénouement inevitable, tragic, but ultimately both just and morally uplifting.

The villain of the piece is Greece itself: a bloated and inefficient public sector, rampant corruption, and decade-long fiscal incontinence partially shielded from public scrutiny by unreliable (if not worse) statistical reporting. Other leading roles in the drama are played by gullible European policymakers who admitted the country, under false pretenses, into the euro club. Cassandra is played by the European Central Bank, warning – alas in vain – of the perils of transgressing against the iron laws of actually existing monetary union. Bondholders, ‘the markets’, and fiscally prudent countries have heroic roles as fearless (if belated) tellers of truth to power.

Character flaws and the grim reality of fiscal arithmetic drive the plot inexorably forward. The country is admitted to EMU, fails to mend its errant ways and lives way above its means. Fate intervenes in the form a global crisis that reveals the extent of the villain’s character weaknesses. The outcome is a tragic increase in unemployment and falling incomes. As it is suffered, though, by the villain itself, the Greek tragedy serves as a valuable lesson on the importance of fiscal rectitude and an opportunity to repent, before it is too late. Any attempt to alleviate the tragedy would blunt the important lesson and only invite others to repeat Hellenic follies.

Greek tragedy, in short, as morality play. This account – and if you think I am building a straw man look here – shares with other morality plays at least three serious problems. It vastly oversimplifies reality. It gives those who believe themselves to be virtuous an unjustified sense of superiority and blinds them to their own failings. Lastly, and most importantly, it serves as a dreadful guide to future behaviour and policy. To bring the script closer to reality, the following must be considered.

Greece is certainly a flawed character, but a multifaceted one, containing elements of villain, but also of victim and innocent bystander. There has certainly long been endemic inefficiency in the Greek public sector and in tax collection. But this is essentially a problem for Greek citizens, who suffer poor and expensive public services; it is not an issue of fiscal irresponsibility as such, nor clear that the bond markets are justified in suddenly pouncing on it. Indeed, the ‘underlying’ fiscal position of such a country is in fact actually stronger in that there is scope to raise tax revenues more quickly and at less cost in terms of real output than in a country with a well-managed administrative system. The false reporting of data is obviously inexcusable (even if the recently emerged complicity of Wall Street banks now speculating on Greek CDS suggests that even here reality is more complex).

There are more fundamental reasons to doubt whether financial markets are justified in singling Greece out. Certainly, the country should have done more to bring down debt levels when economic growth was strong. But in the current hysterical atmosphere a cool look at the 'official' data shows that Greece's current deficits and government debts as a share of GDP have moved almost exactly in parallel with the EU15 averages since the mid-1990s, respectively 2-3 percentage points of GDP lower and some 30 points higher. These differentials have been very stable. This reflects the fact that Greece has had substantially faster nominal GDP growth (that is output measured in current prices) than its neighbours, making repeated higher deficits fiscally sustainable. The recent worsening of the deficit, to around 12%, brings it to about the same as those Anglo-Saxon paragons – the UK, Ireland and the US – and has clearly primarily to do with the impact of the financial crisis including rescuing the banks. Just a few months ago there was a consensus that this crisis was not least the fault of the very financial market players that are now betting against Greece; there is now a clear trend towards putting the blame back on more usual suspects: venal politicians, the public sector and 'untrustworthy southerners'.

Apart from the debt and deficit level (which in Greece are high but not exorbitantly so), there are two decisive sustainability parameters, the interest rate and the (nominal) growth rate. Looking at both, this casts doubt on the heroic role of the supposed 'good guys' in the drama.

Debts and deficits, even of Greek proportions, are easily financed if interest rates are low. At previously prevailing interest rates of around 3%, interest payments are manageable (if debt is 100% of GDP they are, logically, 3% of GDP. In Japan they are around 1% of GDP even though government debt is twice annual GDP, because interest rates are so low.). When rates shoot up to closer to 10%, the risk of snowballing deficits and ultimately default clearly increases. Yet the reason behind the increase in rates is a massive and sudden increase in the 'spreads' demanded over 'safe' German treasuries. It is very clear that some financial market actors are extracting rents by painting a crisis on the wall, which drives up spreads, creates profitable speculative hikes in CDS prices (in which financial actors have no 'insurable interest') as investors follow the stampeding herd; this makes the fiscal crisis a self-fulfilling prophecy. This is not a conspiracy theory: have the lessons of the crisis concerning the damage that unregulated 'financial markets' driven by perverse incentives cause been so quickly forgotten?

Greece's finances were until recently stable because it had faster real growth than other countries (good) and higher inflation (bad). The latter led to a loss of competitiveness that can no longer be resolved through devaluation and is the main reason for concern about the fiscal outlook. It is also why some actors, especially the German government (and popular opinion there) and the ECB point the finger at the Hellenic villain: Greek problems are home made. But the position of these actors is shaky. Competitiveness is a relative concept in a monetary union. If Greece broke EMU's 'rules' by allowing faster wage growth than productivity gains, then other countries, and most spectacularly Germany, also failed to keep them: Germany has lived 'below its means', running-up huge export surpluses and gaining market share at the expense of Greece and other 'peripheral' EMU countries. Keynes' insights of three-quarters of a century ago are sadly forgotten: if everyone acts like Germany, it will tip the euro area into a deflationary death-spiral. The ECB should be careful what it wishes for.

A critical analysis of the play's script has shown that Greece is far from blameless, but it is not wholly so. Moreover, a realistic look at the finger-pointing heroes reveals a lot of peeling gold-leaf and drooping laurels. Is what we are witnessing then more a European farce than a Greek tragedy?

That depends largely on the dénouement. Currently that seems as straightforward as it is painful: massive fiscal contraction in Greece in order to bring the deficit down from around 12% of GDP to 3% in just three years; indeed, this is widely considered not tough enough. Yet, the immediate effect of such pro-cyclical tightening will be to drive down both real output and inflation. Both will make achieving the fiscal targets (which, do not forget, are not absolutes, but expressed as a percentage of nominal GDP) all the harder. Indeed the tougher and bolder the cuts, the greater the risks of a deflationary spiral in which the fiscal numbers could well worsen.

This is a hugely costly strategy which – even if ‘Greece’ is really a miscreant – will hit many innocents (a fact that does not seem to trouble the ‘moralists’). If private demand is depressed, firms are cutting back on investment and the government slashing its budgets, where will higher demand come from? Ah yes, the European chorus, led by Germany, chants: Lower wages and prices will increase Hellenic competitiveness! Exports are its salvation! The cruel plot twist, however, is that the rest of Europe, again led by a Germany relentlessly expanding its market share and exporting disinflation and unemployment, is all trying to do the same thing at the same time. Gaining market share through so-called ‘internal devaluation’ is at best a zero-sum game. At worst, it is a recipe for continent-wide stagnation. That would be to tread a path from Greek tragedy via European farce to European tragedy.

The ending of any play, though, is at the discretion of the playwright. If I were writing the script it would read something like this: the European Council and ECB jointly declare immediate financial support, burning speculators fingers, driving down interest-rate spreads; Greece accepts enhanced supervision of its public finances and announces a longer-term fiscal consolidation package designed to have as limited negative effects on demand as possible in the short run (notably drastically reducing tax evasion), but primary fiscal surpluses in the medium run; it couples this with a freeze on wages and administered prices and policies to increase product market competition; meanwhile Germany and other surplus countries commit to fiscal stimulus and a period of faster-than-productivity-growth wage increases; the ECB holds interest rates at zero and announces the transition to a redefined price stability target of close to, but below 4%; this raises the nominal growth rate and permits competitive imbalances within EMU to be worked off over the coming five years without massive deflation in deficit countries.

As a result of this policy mix, the European economy experiences three years of above trend growth – during which financial markets are thoroughly reformed – bringing unemployment, deficits and debts down at least to pre-crisis levels. Prompted by the crisis, it heeds Cassandra's warnings, but in a positive way, and belatedly starts to put in place the machinery for fiscal governance and close economic policy cooperation needed to make a monetary union work for all its citizens. These include emergency lending procedures, closer but symmetrical fiscal and current account monitoring, and tax-policy coordination.

Wrong-headed ideas on fiscal policy and economic governance and misplaced notions based on simple morality plays have caused enough tragedies in Europe (and elsewhere). It's time for some real-life happy endings.