

The Greek Aftershock – Will it Make or Break Europe?

[Steven Hill](#) on 19.02.2010



After the earthquake come the aftershocks. That is a law of geophysics, and now apparently of economics. Well over a year ago, the world economy suffered a massive economic quake of 8.0 on the Richter scale. Since then different countries have been experiencing a number of aftershocks.

Two aftershocks have grabbed headlines, one recently in Greece and another last summer in California. A comparison of these two events is illuminating as they reveal something about the respective features of the West's two leading capitalist economies, the United States and Europe.

The Greek aftershock has roiled the financial markets in recent weeks. With some \$25 billion worth of loan payments coming due for which Greece will need to refinance, the bond markets became skittish that a Greek default may lead to a wave of other national defaults in Portugal and Spain, and drag down the euro itself (much like Lehman Brothers initiated the global financial industry's collapse).

But that seems unlikely. Greece's economy comprises only 2% of the overall European economy – about the same magnitude as Indiana's in the United States. Greece's deficit to GDP ratio, while high at about 12.5%, is not that much higher than that of both the US and Japan, around 10.5%. True, Greece has a sizable accumulated debt over many years, estimated at about 110 percent of its GDP, but even the US has a debt to GDP estimated at 94 percent and projected to break 100 percent by 2012. And Greece is embedded within the eurozone, which actually has a fairly low deficit to GDP ratio by today's post-collapse standards, only 6%. So there is little doubt that Europe has the capacity to absorb Greece's troubles. This is more a matter of investor confidence, not economic fundamentals.

California by comparison makes up 14% of the US economy, about the same magnitude as Germany's economy in Europe, truly 'too big to fail'. Yet when California threatened to default on its loan obligations last summer and Governor Arnold Schwarzenegger asked for a federal bailout, the Obama administration flatly rejected it. That caused California to have to issue IOUs as a way to pay its bills, and its bond rating plummeted.

California's situation in some ways is more worrisome than Greece's. Having a state that is one-seventh of the national economy in dire straits is a threat to the nation's

economic recovery. It is analogous to having Germany struggling instead of Greece, striking at the heart of Europe. California has been shaken by widespread layoffs and furloughs – the city of Los Angeles just laid off 1000 more workers – and core social programs have been slashed. Millions of low-income children have lost access to meal programs, and community clinics have been closed. Almost three million low income adults have lost important benefits such as dental care, psychological services and mammograms.

In addition, while both California and Greece are in major belt tightening mode, at least in Greece all families and individuals still have access to health care and a long menu of other social supports that Europe is known for. In California, even before the crisis, millions had no health care, and now more have lost their jobs and their health insurance. Unemployment compensation is miserly, as is the overall safety net, which impacts consumer spending and further weakens the economy.

But California and the US do have one advantage over Greece and the European Union. Certainly Europe has the capacity to handle this crisis – it's economy is nearly as large as the US and China combined – but that's only if its big eurozone economies, Germany and France, are willing to lead. While the American federal government is used to playing the role of financial backstop for the states, making loans and other guarantees to weaker EU members is a new role for Germany or France to play.

The Germans and French are about to get a real dose of what 'union' means. They didn't realize that the euro came with a hidden obligation for them to bail out the Greeks and perhaps others during tougher economic times. So far they have agreed to stand behind Greece in return for new restrictions on government spending, but this crisis is going to test their union.

Will this mean the end of the EU, or the euro, as some doom-and-gloomers are predicting? Quite the contrary, says Tommaso Padoa Schioppa, former Italian Minister of Economy and Finance who is considered one of the founders of the euro. He said in a recent interview that the Greece situation 'confirms the necessity and role of the euro in a very clear way'. The crisis, he says, will bind the EU closer together and ultimately strengthen it as all sides recommit to this union-in-progress. The EU member states have swum too far across that stream to turn back now.

This episode also may result in a hidden silver lining for Germany and other export nations, since it already has led to a slight drop in the value of the euro, and that will make their exports less expensive. Since Germany seems determined to export its way out of this economic crisis, that could have some desirable effects.

While the current situation is messy, the EU often has evolved and changed in reaction to a crisis. After each crisis the partner nations come up with new informal rules and agreements to patch up things and move on. And then every 15 years or so they take all the previous agreements and put them into a treaty, i.e. Maastricht, Lisbon, etc. Everyone has their crystal balls out, trying to divine Europe's future. Indeed, when the euro was first launched, many predicted it would fall flat on its face. But the Eurosceptics have predicted the end of Europe before and got it all wrong.