DOC. N.º 16

BBC NEWS Idle Scrawl Paul Mason's blog newsnight

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Greece is not Europe's Lehman: Spain would be. But it's avoidable

Post categories: Budget deficit

Paul Mason | 11:33 UK time, Thursday, 29 April 2010

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Yesterday's developments summarised: *Merkel and Strauss-Kahn meet and no bailout is forthcoming. Strauss-Kahn tells German MPs that the final bill could come to E120bn, for Greece alone. The boss of the OECD calls the contagion "Ebola" and though this comes out at lunchtime, when Bloomberg wires it during the close of the London markets, they temporarily tank. An analyst from JP Morgan puts a E600bn price tag on an EU bailout of Portugal, Spain, Ireland and Greece. Nouriel Roubini re-emerges in doom mode warning that Greece is the tip of the iceberg. The whole thing gets a total of four minutes on Newsnight because of Gordon Brown's gaffe...*

So where is it going next, and are the contagion fears overblown? First, from conversations with bond market participants the Greek story has changed and is no longer about whether a bailout will happen: once the word "haircut" entered the conversation, the markets were spooked. If the Greek bailout is so big that governments insist bondholders take a hit, to the tune of a 50% loss (or "haircut") on what they are owed, then it is time to lessen your exposure to south-European sovereign debt.

Fund managers are judged by their performance. Long-term asset managers, for example pension fund managers, are so heavily into sovereign debt that any debt write-offs on this scale are "career finishing events", says one source. They're used to thinking of 2% losses on sovereign debt as large. 50% means, well, sovereign debt does not exactly deserve the moniker "gilt edged" anymore.

Bond strategists have started to analyse what's happened in the past - with South Korea or GM - where the debt becomes junk, a restructuring happens and then the value of the bonds come back. It is not looking pretty - you rarely get your money back - hence the contagion.

The market in Greek debt, says Graham Turner of GFC Economics, is effectively broken. If Portugal goes the same way then whatever template the EU creates for Greece will have to be applied to Portugal, then Ireland and Spain come under pressure.

Since many banks also hold south-European debt and use it as collateral to borrow from the European Central Bank, this could spread the contagion to the banking system. It already looks likely the ECB will start to swap its good money for the banks' junk, just as the Bank of England did.

OK - that's the "markets" part of the contagion story. Now here's the political economy: if you read the S&P, Fitch, Moody's etc notes about the so-called "PIGS" countries, one theme comes back again and again: total lack of realism by governments about the scale of cuts and tax rises needed, total over-optimism about the growth they can expect.

S&P for example predicts 0.7% annual growth for Spain out to 2016. The Spanish government is talking about >2%.

So what is emerging is a disconnect that does remind you of the build up to the Lehman collapse.

You get the discovery of dodgy data (incoming Pasok government finds books in much worse state than imagined); then you get denial; then you get the crunch where the authorities say to an institution's peers "guys you gotta bail them out or you go down with them".

In Lehman's case we know what happened. The banks refused to bail out Lehman and the US government let it fail. With Greece, it is by no means certain that the bailout will happen. As its estimated cost rockets, and the political consequences become clear, you are already getting an incremental version of what happened with Lehman - that is the EU governments passing the buck to the IMF, just as Goldman, Citi and JP Morgan passed the buck to Hank Paulson.

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About this blog

I'm Paul Mason, Newsnight's economics editor, a job that takes me from Kenyan shanty towns to Russian hedge funds and Chinese factories. My blog is called Idle Scrawl. It veers wildly across the subject: from house prices, to global poverty; from deconstructing glib terminology to devastating critiques of the England football management. It is occasionally meant to be funny. Follow me on Twitter

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But even if Greece goes bust it can be contained. Even if it costs, as Strauss-Kahn says, 120bn Euros, the IMF could do that. It could call on the world to help, not just the *kleinburgerlich* electors Nordrhein-Westfalia.

But let's get to the root of why that might not be enough.

Lehman sparked a systemic liquidity crisis because Wall Street's bosses looked at each other and said, "you know what, I don't trust you: I only trust myself". Even as the big bosses frantically ordered their traders to go on trading with their rivals, market logic forced them to stop trading and stab each other in the back. It was a crisis, in the end, of credibility.

As the financial crisis has become a fiscal crisis, it is now the credibility of states that is in question. The credibility of their bailout pledges and of their deficit reduction plans.

If Germany and France have to bail out Greece, the first question is - will their electorates buy it? If not, then the EU-managed bailout solution is not credible.

But there is a much bigger problem of credibility among the stricken countries. There is no evidence whatsoever that they can impose the necessary austerity on their populations to meet the conditions of the bailouts. With Ireland, worse, there is a dawning realisation that its tough deficit reduction plan, lauded as a model for others, may not be enough.

What has to be stressed here is that we are in a totally unprecedented situation. With all debt defaults in the past there has been a strong creditor group of countries that took control of the process; even to the extent of manipulating the politics of the stricken countries, as the United States did to Latin America in the 1980s.

But now it is the developed world that is in danger of going bust. For the past two years governments have improvised a rough-and-ready Keynesianism. But that response is now in crisis.

Keynes himself never advocated strategic use of budget deficits: he advocated temporary fiscal expansion (tax cuts and spending increases) to boost growth and soak up excess labour, with deficits as the price. Keynes' chosen methods were monetary: manipulate the currency, print money.

In the Depression, those who ran up deficits never went much higher than 5% of GDP. And remember this was in an era of closed markets - we're now in an era of floating exchange rates and open capital markets where running a giant permanent deficit is only really an option for self-contained markets like Japan, or a dominant superpower like America, and then comes with huge eventual downsides.

We will never know what would have happened if the Brits had simply nationalised Northern Rock on day one, if Paulson had let Bear Stearns go bust and bailed out Lehman instead. But there is every chance that if the EU and IMF handle the Greek bailout deftly, the contagion stops at Greece. If they do so they will demonstrate the competence of institutions that badly need to demonstrate it. They will restore credibility.

But if the Greek bailout is delayed so long that it infects Portugal, then Spain drifts into the crosshairs. I cannot see the northern Europe finding the equivalent of 8% of GDP for Spain.

Just as the Germans are finding reasons to dislike the Greek lifestyle (except for the one month a year when they choose to live it), northern Europe will surely find a reason to dislike Spain's. "They've lived an unrealistic lifestyle" will be the refrain - even if that lifestyle involves glorious football and Almodovar-style high jinks, rather than kleftiko and retsina.

Spain, like Lehman, could be too big to bail, say people in the markets.

And here is the unspoken politico-economic truth about this crisis: America has transferred the pain of the crisis from banks to taxpayers, but it has not imposed austerity. The US is still in the middle of its fiscal stimulus. Ditto China. That leaves Europe, where the logic of saving the banks using taxpayers' money means that the European population pays the price.

It will be noted that each of the stricken countries is a "young democracy": (Greece overthrew the junta in 1974; Portugal underwent a revolution in 1974; Spain saw armed officers attempt to storm its parliament as late as 1981).

In retrospect we can see how the wounds of left-right battles in the 1970s were finally healed by the rapid, speculative growth that came with Euro-entry. The Balkan wars show us how easy it is to reopen old wounds.

For these reasons, imposing the cost of the banking crisis on the population of Europe is going to be hard. The north-European electorates will be disinclined to vote for it; we've seen, with the IFS report, how disinclined British politicians are to tell us the truth about the scale of the coming cuts. And the south-European population - whose iconic type is no longer the anarcho-syndicalist dock worker but the unemployed trendy graduate - will not very likely put up with it.

There are ways out: break up the Eurozone; hand the problem to the IMF, setting back for a generation the EU's claim to fiscal authority. You could inflate the entire problem away, but unless you cut Europe adrift from the international markets it would provoke further mayhem. You could impose more of the cost of the banking crisis on the bankers themselves - through aggressive nationalisation and breakup.

But in the end, the price you pay for a system wide financial crisis comes down to this: either your own population pays for it, or you pass off the cost to somebody else.

Does this play into the British debate on fiscal policy? You bet it does. Market participants know that if the whole of south Europe catches the contagion then Britain's immune system is already compromised. Will it provoke a sudden outburst of clarity about the unspecified cuts they plan (£52bn for the Conservatives, £44bn for Labour, £34bn for the Libdems) in tonight's debate? We'll let you know.

* *Watch it live on the BBC and then tune to Newsnight on BBC TWO for instant analysis*

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Comments

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1. At 12:32 29th Apr 2010, **flicks** wrote:

Another bang on job Paul

Hopefully people will see that Birmingham isn't such a dump from the pre-debate shots and talk. Birmingham University is an attractive place - during the eighties I would visit the Barber Institute (which is with-in Birmingham Uni) on a regular basis to study art. I can recommend it for any of the media who maybe have half an hour or so to spare - spy a great Edgar Degas or just walk around a beautiful building in quiet and get away from all the hype and sovereign debt crisis.

complain about this comment

2. At 12:49 29th Apr 2010, **tonyparksrun** wrote:

Excellent piece Paul...Grand Canyon in full view...is that the Colorado River twinkling at the bottom or the lights of prosperity going out all over Europe?[we shall not see them again in our time] (excuse the distorted quote from Sir Edward Grey)

complain about this comment

3. At 12:54 29th Apr 2010, **stevie** wrote:

this could be the turning point...and it started in Greece where most good things start like civilisation, democracy etc., we never get to vote in the EU like er, the constitution !!! They do not publish accounts, imagine anyone else trying that one for 15 years!!! It is the gravytrain to beat all gravytrains. It is right wing centralist with no accountability and should be disbanded...maybe the Greeks have found a novel way of starting that process...hopefully....

complain about this comment

4. At 13:11 29th Apr 2010, **tawse57** wrote:

Fascinating blog Paul - very interesting.

Personally I cannot see the German people agreeing to bail-out Greece. Merkel could force it through but I expect that would result in Germans taking to the streets.

Hence any Greek, let alone PIIGS bail-out, would fail at the first hurdle.

complain about this comment

5. At 13:34 29th Apr 2010, **DebtJuggler** wrote:

'King: Election winner will be out of power for a generation'

http://blogs.telegraph.co.uk/finance/edmundconway/100005270/king-election-winner-will-be-out-of-power-for-a-generation/

complain about this comment

6. At 13:48 29th Apr 2010, **DebtJuggler** wrote:

Anyone else remember 'The Greatest Show On Legs'?

Three naked men...and only two balloons to go round!

http://www.videosift.com/video/The-Greatest-Show-On-Legs-The-Naked-Balloon-Dance

'Beggar thy neighbour' may become the only game in town, as far as the 'rich' nations are concerned! http://en.wikipedia.org/wiki/Beggar_thy_neighbour

complain about this comment

7. At 14:32 29th Apr 2010, **Jericoa** wrote:

Not that you need praise from me, but well done Paul, excellent piece, clear precise and unspun with a common logical thread throughout and a bit of creativity thrown in also.

Right on the money and contained all the things I look for when checking calculations, attempts at misdirection and manipulation jump out at me in calcs as they do in journalism and politics.

Glad you are around to keep the likes of me sane, because to be sure, in times not too far away the world will need engineers like me to remain sane and be on our game to help clear up the mess the lawyers, bankers, politicians and estate agents types have left for us.

I am trying, I really am, but I am srugging to see (based on past performance) how the current generation of european leaders are morally and technically equiped and brave enough to do the right thing here to 'avoid it'.

They may manage to contain it for alittle while longer but i just dont see anybody grasping and confronting the underlying situation, formulating a viable (least damaging) solution and communicating that in an unleveraged way and with vision to the people.

I am sorry, I really am, but I just can not see it, I wish I could.

complain about this comment

8. At 14:32 29th Apr 2010, **shireblogger** wrote:

Good piece, Paul. In a way, sovereign debt contagions are potentially more dangerous than dealing with bank contagions. In dealing with banks the politicians had regard to millions of innocent voters and their deposits in need of protection. Easier to make the case for intervention. However, if the source is a feckless sovereign country the reason to act becomes blurred by nationalistic and cultural objections without the wider universal goal of protecting all savers.The need to protect the "eurozone" or the euro-ideal is not a universal goal shared by all global politicians. Unless savings are universally threatened, as they were in 2008, the dynamics are different now.I agree it could be more dangerous, therefore. More room for self interested behaviour.

complain about this comment

9. At 14:41 29th Apr 2010, **copperDolomite** wrote:

Good post.

I'm going to read it again before the debate tonight.

Seems you are saying globalisation is like having the world's light bulbs wired in series when parallel would have been wiser? What a fine and dandy idea that was!

complain about this comment

10. At 15:18 29th Apr 2010, **watriler** wrote: