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Greece, the Latest and Greatest Bubble

By Peter Boone and Simon Johnson March 11, 2010 6:44 am

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Bubbles are back as a topic of serious discussion, as they were before the financial crisis. The questions today are: (1) Can you spot bubbles? (2) Can policy makers do anything to deflate them gently? (3) Can anyone make money when bubbles get out of control?

Our answers are: (1) Spotting pure equity bubbles may sometimes be hard, but we can always see unsustainable finances supported by cheap credit. (2) Policy makers will not act because all great (and dangerous) bubbles build their own political support; bubbles are invincible, until they collapse. (3) A few investors can do well by betting against such bubbles, but it's harder than you might think because you have to get the timing right — and that's much more about luck than skill.

Bubbles are usually associated with runaway real estate prices or emerging market booms or just the stock market gone mad (remember Pets.com?). But they are a much more general phenomenon — any time the actual market value for any asset diverges from a reasonable estimate of its "fundamental" value.

To think about this more specifically, consider the case of Greece today. It might seem odd to suggest there is a bubble in a country so evidently under financial pressure, and working so hard to stave off collapse with the help of its neighbors.

But the important thing about bubbles is: Don't listen to the "market color" (otherwise known as ex-post rationalization); just look at the numbers.

By the end of 2011 Greece's debt will be around 150 percent of its gross domestic product. (The numbers here are based on the 2009 International Monetary Fund Article IV assessment.) About 80 percent of this debt is foreign-owned, and a large part of this is thought held by residents of France and Germany. Every 1 percentage point rise in interest rates means Greece needs to send an additional 1.2 percent of G.D.P. abroad to those bondholders.

Imagine if Greek interest rates rise to, say, 10 percent. This would be a modest premium for a country with the highest external public debt/G.D.P. ratio in the world, a country that continues (under the so-called austerity program) to refinance even the interest on that debt without actually paying a centime out of its own pocket, while struggling to establish any backing from the rest of Europe. At such interest rates, Greece would need to send at total of 12 percent of G.D.P. abroad per year, once it rolls over the existing stock of debt to these new rates (nearly half of Greek debt will roll over within three years).

This is simply impossible and unheard of for any long period of history.

German reparation payments were 2.4 percent of gross national product from 1925 to 1932, and in the years immediately after 1982 the net transfer of resources from Latin America was 3.5 percent of G.D.P. (a fifth of its export earnings). Neither of these were good experiences.

On top of all this, Greece's debt, even under the International Monetary Fund's mild assumptions, is on a non-convergent path even with the perceived "austerity" measures. Bubble math is easy. Hide all the names and just look at the numbers. If debt looks as if it will explode as a percent of G.D.P., then a spectacular collapse is in the cards.

Seen in this comparative perspective, Greece is still going bankrupt unless it gets a great deal more European assistance or puts a much more drastic austerity program in place. Probably it needs both.

Given that there's a definite bubble in Greek debt, should we expect European politicians to help deflate this gradually?

Definitely not. In fact, it is their misleading statements, supported in recent days (astonishingly) by the head of the International Monetary Fund, that keep the debt bubble going and set us all up for a greater crash later.

The French and Germans are apparently actually encouraging banks, pension funds and individuals to buy these Greek bonds — despite the fact senior politicians must surely know this is a Ponzi scheme (i.e., people can get out of Greek bonds only to the extent that new investors come in).

At best, this does nothing more than postpone the crisis. In the business, it is known as "kicking the can down the road." At worst, it encourages less informed people (including perhaps pension funds) to buy bonds as smarter people (and big banks, surely) take the opportunity to exit.

While French and German leaders make a great spectacle of wanting to end speculation, in fact they are encouraging it. The hypocrisy is horrifying. President Nicolas Sarkozy of France and Chancellor Angela Merkel of Germany are helping realistic speculators make money on the backs of those who take misleading statements by European politicians seriously. This is irresponsible.

What should be done? In three steps:

1. The Greeks and the Europeans must decide: Do they want to maintain the euro as Greece's currency, or not?

2. If they want to keep the euro in Greece, the Greeks need to come up with realistic plan to start repaying debt soon. Any Greek plan will not be credible for the first few years, so the Europeans must finance the Greeks fully. This does not mean spending 20 billion euros; rather, it means making available around 180 billion euros, that is, the full amount of refinancing that Greece needs during this period.

3. If they don't want to keep the euro, then they should start working now on a plan for Greece's withdrawal. The northern Europeans will need to bail out their own banks, because Greek debt must fall substantially in value. Euro-denominated debt will need to be written down substantially or converted to

drachmas so it will be partially inflated away. The Greeks can convert local contracts, and deposits at banks, to drachmas. It will be a very messy, difficult transition, but the more the debt bubble persists, the more attractive this becomes as a "least awful" solution.

Regardless of the decision on whether Greece will keep the drachma or give it up, the I.M.F. should be brought in to conduct the monitoring and burden share.

The flagrant deception that we now observe — as the Europeans claim that the Greeks have taken a big step forward, and encourage people to buy Greek bonds — proves they do not have the political capacity to be realistic about this situation. Who can now be believed when it comes to discussing needs for Greek financial reform and formulating a credible response?

The only credible voice left with the capacity to act is the I.M.F. — and even that body risks being compromised by the indiscreet statements of its top leadership as the bubble continues.

If such measures are not taken, we are clearly heading for a train wreck. The European politicians have been tested, and now we know the results: They are not careful. They are reckless.