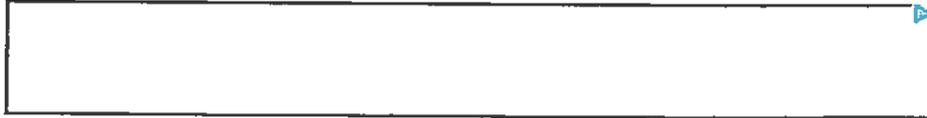


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THE BLOG

Standing At Thermopylae: Greek Economic Situation Worsening Fast

🕒 06/08/2010 05:12 am ET | Updated May 25, 2011

Simon Johnson

Author, 'White House Burning: The Founding Fathers, Our National Debt, and Why it Matters To You'



By Peter Boone and Simon Johnson, cross-posted with [BaselineScenario.com](#)

No one in official Washington is seriously worried about Greece. It's far away, relatively small, and - anyway - "we already sent the IMF". Under current circumstances, this is very much like saying 2,500 years ago: We sent 300 Spartans to stand against a horde of Persians, so what's the problem?

The Greek economic situation is worsening fast - with government bond yields rising rapidly today (currently the 10-year rate is around 7.5 percent). Unless there is rapid action by the international community, this has the potential to get out of control.

There are three scenarios to consider: the nightmare, the "savior", and the decision.

Nightmare scenario: No one makes a quick decision, and bond spreads for other relatively weak eurozone countries take off. "Core Europe", such as Belgium and France, are also hit by higher bond yields. At that point, the EU does something small for Greece, but that does not really address the worsening problems elsewhere. Real interest rates remain differentiated across Europe, with Germany very low and the periphery very high. This causes very different growth rates, feeds into strikes, and budget deficits worsen. European banks take capital losses so (again) need to recapitalize. The periphery banks need their recapitalization to be funded by the state, which increases national debt. At some point soon a European country defaults. Then there is a wave of defaults.

"Savior" scenario: Phone Larry Summers, and he will help arrange another round of unconditional bailouts for all creditors everywhere - perhaps on scale that makes the 13 bankers episode look small. The strategy will be to welcome all the moral hazard back into the system so people feel the risk of state (and private) bankruptcy is zero. Each day we delay now, Mr. Summers and his colleagues will have to provide more largesse - and more distortion - when they finally come in. For example, they could do a new round of "stress tests" and decide that each European nation has a good enough plan to reduce its budget deficit. Perhaps the eurozone nations agree to a common tax or fiscal mechanism to help each other through transfers. They then open the European Central Bank (ECB) lending windows to all those countries. Investors realize they are safe because the

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ECB shows it has no backbone - maybe Mr. Trichet resigns but probably not, so the spreads come in, etc. The moral hazard issues are mind-boggling, and it would very hard to get any teeth into the system after that. The financial markets would, of course, in the short term stand up and applaud - until they thought through and began to understand all the consequences for government balance sheets.

Decision scenario: As we laid out at length on Tuesday, Greece faces only hard decisions involving some combination of: much more fiscal austerity than is currently in the cards, debt restructuring (also known as default), and leaving the eurozone. Given all the players involved on the European side, it is hard to see how they take any of these decisions soon. This is why "prompt correction action" is never prompt and rarely truly corrective - politicians in this situation (and regulators more generally) have an incentive to delay taking hard decisions that will encounter serious pushback; they would rather wait for events - either they will get lucky or, more likely, they will be forced in a particular direction. But this is exactly how you get forced to a decision point where the only options really are "global collapse or overly generous rescue that creates major problems down the road".

The US needs to step forward with some clear leadership on these issues. The situation would still be difficult, given the attitudes and fractious nature of Europe. But Washington will not even try - the White House still doesn't understand what it has helped create and the dangers that this poses.

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