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Greece is Europe's very own subprime crisis

By Wolfgang Münchau

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Portugal's problems are different but they are no less severe

This is going to be the most important week in the 11-year history of Europe's monetary union. By the end of it we will know whether the Greek fiscal crisis can be contained or whether it will metastasise to other parts of the eurozone.

By then, the International Monetary Fund and the Greek government should have reached a deal. There are three things to watch out for. First, and most important, Greece will need to present a transition programme that explains how a large primary deficit can be turned into an equally large primary surplus without causing a slump in economic growth. What I have heard so far from Greek economists is deeply discouraging. Most of the suggestions are old-fashioned accounting tricks, such as trying to add estimates of the black economy into the official number for gross domestic product. What we should be looking for is a three-year programme that lays out detailed expenditure cuts and structural reforms.

Second, the total loan package has to be substantially higher than the €45bn pledged so far (of which €30bn is from the European Union, and the remainder from the IMF). The EU's contribution is for one year only, and I see little chance that the EU will be able to increase it either now or next year. Axel Weber, president of the Bundesbank, has estimated that Greece will need about €80bn for the entire period of adjustment. That is about right. What we need to hear is a credible and watertight commitment that extends beyond €45bn. Greece will need cover for at least two years – during which all of the policy adjustment has to be decided, and most has to be implemented.

Third, we need to watch the situation in Germany. The government originally tried to tag the Greek loan legislation on to an existing piece of legislation, but this ran into opposition. There will now be a full legislative process. Some parliamentarians from Angela Merkel's coalition have already cast doubt on whether they will support it, including the parliamentary leader of the Bavarian CSU, the sister party of Ms Merkel's Christian Democrats. They argue that the best solution would be for Greece to leave the eurozone and rejoin later. On this point, they are supported by large parts of the country's legal and economic establishment.

Their argument is full of legal hypocrisy. Those who make it pretend to care deeply about the strict fulfilment of the Maastricht Treaty's "no bail-out" clause. Yet they see no problem in advocating a breach of European law by proposing a Greek exit from the eurozone. Under existing law Greece cannot be pushed out. In fact Greece cannot leave the eurozone voluntarily, without having to leave the EU as well. In any case, it is smarter for Greece to default inside the eurozone than outside. So what happens if the Bundestag blocks the aid? Greece will simply default, and this will put several German and French banks that hold large chunks of Greek sovereign and private debt at risk.

Of the three points to watch out for, we will have certainty on points one and two by the end of this week. On the third point, the discussion will drag on. Ms Merkel is determined to push the resolution beyond May 9, the date of the regional elections in the German state of North Rhine-Westphalia.

I have often wondered during the crisis what it would take for Europe's political leaders to get ahead of the situation. There are many co-ordination problems and too many self-important people to be consulted, most of whom lack an understanding of what is going on and have a wrong sense of priorities. In such an environment, accidents happen. So far the EU's policy process has been a net contributor to this crisis. We need to hear something that does not fall short of our lowest expectations. Otherwise Greece will be heading for default, and the crisis will spread to Portugal and beyond.

Just as unhappy families are unhappy in their own distinct ways, Portugal is different from Greece. But its problems are no less severe. The problem in Portugal is not the state sector. Portugal's gross public sector debt is projected by the EU to be about 85 per cent of gross domestic product by the end of this year. This is high, but not exceptionally so. On my calculations, using data from the World Bank, Portugal's external debt-to-GDP ratio, including public and private sectors, is a staggering 233 per cent – the government at 74 per cent and the private sector 159 per cent. The net international investment position is about minus 100 per cent of GDP – the amount by which Portugal's financial assets abroad are outweighed by assets owned by foreigners in Portugal. The current account deficit is projected to remain at just under 10 per cent of GDP. This is an acute private sector crisis. And like Greece and Spain, Portugal has lost competitiveness against the eurozone average of some 15 to 25 per cent during its first decade in the eurozone.

What we are seeing here is Europe's equivalent of the US subprime crisis. Unless we hear some implausibly good news from Athens by Friday, it will soon blow up.

munchau@eurointelligence.com
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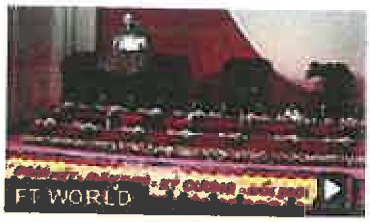

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