

## Beware Greeks Bearing Gifts

Michael E. Lewitt

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“Whatever it is, I fear the Greeks even when they bear gifts.”  
Virgil, Aeneid, Book II

Whatever the outcome of the Greek economic drama, the fact that a relatively small country can cause the global financial markets to sell-off so sharply illustrates how interlinked the global markets remain in the wake of the 2008 financial crisis. Years of short-sighted fiscal and monetary policy have trapped Western economies in a boom and bust cycle from which there is no easy escape. As a result, global markets remain highly vulnerable to instabilities at their periphery. Greece is a case in point, but it is only a symptom of the deeper disease ailing the global financial system.

In an interconnected world, however, there is no such thing as a periphery. The system is only as strong as its weakest link. A Greek default would cause financial turmoil because as much as E250 or E300 billion of Greek debt is owned by international bond funds, pension funds, insurance companies and banks. All of these institutions – banks in particular – are undercapitalized and would be further impaired if Greece defaulted. American banks have \$176 billion of exposure to Greece, according to Barclays Capital. There will be considerable behind-the-scenes pressure brought to bear to prevent a default.

Greece plans to reduce its fiscal deficit from 13 percent to 2 percent of GDP by 2013. Whether or not this plan is achievable, it illustrates the degree of austerity that will be required to bring not only Greece's but other sovereign balance sheets into balance, including Spain, Portugal, Italy, the UK and the United States. The prospects for success are minimal without radical changes in entitlements and reductions in these countries' already fraying safety nets. Moreover, the impact of efforts to reduce government spending inevitably will be deflationary; there is virtually no way that the withdrawal of almost 10 percent of GDP (which represented the government contribution to economic growth in many countries in 2009) can prove to be anything other than a deflationary shock to these economic systems. There is no way that private-sector demand can compensate for the withdrawal of government stimulus on this scale.

For *El Mundo's* readers, Greece's problems are an ominous sign of what the future could hold if Spain's leaders do not take action to rein in deficits and stimulate employment. Some observers, such as Nobel Prize winning economist Paul Krugman, are warning that Spain, not Greece, is the real epicenter of Europe's economic crisis. Mr. Krugman is a bit premature in his warning, but Spain's leaders do not have the luxury of time in dealing with their country's economic woes. With a 2009 budget deficit that reached 11.4 percent of GDP, and a January 2010 unemployment rate of 18.8 percent (twice the European average), Spain's economy is in desperate straits.

Still, the situation could be worse. As Finance Minister Elena Salgado has pointed out, the country's debt-to-GDP ratio remains 20 percentage points below the Eurozone average (although this may be likened to the adage that “In the kingdom of the blind, the one-eyed man is king.”). Spain's debt remains (for the moment) under 50 percent of GDP, well below the EU limit of 60 percent. Most importantly, the Spanish government recognizes the severity of the situation and has begun taking steps

to attack the fiscal challenge. Last week, it announced an austerity plan that increases the retirement age from 65 to 67 and cuts E50 million from the budget by 2013, which will reduce the deficit to an EU-mandated 3 percent. If the government can withstand the inevitable challenge from the unions to these changes, Spain's economy will have a chance.

Spain's unions need to consider what happened in the United States to General Motors and Chrysler, which were driven into bankruptcy in part by unreasonable union demands that failed to recognize the changing competitive environment. The world is changing, and Spain's economy will no longer be able to compete if the country is held hostage by union demands that place undue burdens on government and private sector employers. At the same time, Spain's employers will also have to make sacrifices to insure that workers are not the only ones helping Spain's economy meet the challenges of the 21<sup>st</sup> century. Those challenges are only going to increase in the future.

There are a number of ways in which the EU and the broader world community can assist Greece, Spain and other struggling countries. Bailouts, however, are not the answer. Long-term fiscal and monetary reforms (including progressive tax policies that promote growth and quell speculation) are needed to help weaker economies better manage themselves. But there is another area that could help the global economy avoid the types of market-driven threats that the European crisis is spawning: regulatory reform.

The unfolding Greek drama is once again illustrating the effects of failing to take action to ban naked credit default swaps. Greece's borrowing costs are rising by the day as speculators sell short Greek credit through the credit default swap market. The dynamics of these instruments render it more attractive for their holders to see Greece default than to survive, and for that default to happen as soon as possible to accelerate the payment of the so-called credit "insurance" that is being purchased. These toxic products poison the environment in which governments must make the proper decisions about how to design an appropriate long-term solution to Greece's debt problems. By definition, speculators are looking for short-term answers while the world needs sound long-term solutions to what will undoubtedly be only the first of several sovereign debt crises over the coming decade. It would be a prudent first step for regulators to eliminate the ability of speculators to render it more difficult for countries to finance themselves by banning these toxic products before they inflict further unnecessary damage on the global economy.