Constantinos Simitis

Από: Hardouvelis Gikas
Αποστολή: Τετάρτη, 12 Μαΐου 2010 10:15 πμ
Προς: Constantinos Simitis
Θέμα: Simon Johnson in a good article on the future of the Euro area
Συνημμένα: How the eurozone set off a race to the bottom.doc

A lot of negative material is being written lately.
This article has serious arguments.

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How the eurozone set off a race to the bottom

By Peter Boone and Simon Johnson

May 10 2010 20:53 | Last updated: May 10 2010 20:53

Over the past decade, the eurozone has facilitated one of the largest moral hazard schemes of all time. Until Friday, this operated at two levels.

Spain and Ireland built huge banking systems, drawn into a property bubble – but really based on the rules of the eurozone, which implicitly underwrite its commercial banks without adequate supervision. Portugal and Greece ran old-fashioned out-of-control fiscal deficits, financed by bank lending – with all the debt available to use as collateral for short-term borrowing ("repo") at the European Central Bank; and underwritten by implicit too-big-to-fail guarantees, which became explicit this weekend. The Italians fall into a less extreme category, but they are also in the line of fire due to a mix of imprudent banking and wishful budget thinking.

European banks, too, were happy to participate in this policy delusion – this government paper was "almost no capital required" and "freely available to use for repo" at the ECB.

On top of all this, over the weekend the euro leadership threw everything they (and, with US approval, the International Monetary Fund) had – in liquidity terms – at the problem. The market applauded initially, but now people are doing the sums on the underlying fiscal solvency.

Greece is a complete fiscal disaster. Under the new IMF programme, Greece needs to grow soon out of its debt problem. Greece's debt/gross domestic product ratio will be 145 per cent of GDP at the end of 2011. Using more realistic growth figures – eg, with GDP down 12 per cent to the end of 2011 – then the debt/GDP ratio may hit 155 per cent. At that level, with a 5 per cent real interest rate and no growth, it needs a mind-boggling primary surplus of 8 per cent of GDP to keep the debt/GDP ratio stable.

Portugal is almost as bad. Just to keep its debt stock constant and pay interest on its debt at an optimistic 5 per cent, it needs to run a primary surplus of 5.4 per cent of GDP by 2012. With a planned primary deficit of 5 per cent of GDP this year, it needs roughly 10 per cent of GDP in fiscal tightening. It is near-impossible to do this in a fixed exchange rate regime without massive unemployment.

Ireland is held up as a model to suggest that this is feasible – but despite their austerity, even the perpetually optimistic European Commission thinks the Irish budget deficit will be close to 11.7 per cent of GDP in 2010 and 12 per cent in 2011. Absent a miracle in global growth, it will soon knock on the door of the European Stabilisation Mechanism. Ireland is the canary in the fiscal adjustment coal mine; it looks sickly.

As the economist Willem Buiter remarked last week, governments have the greatest incentive to default when they are running a balanced primary budget (ie, after substantial budget cuts) and still have large government debt outstanding. The incentive structure means they will postpone a decision to default that would otherwise be rational now.

Given the incentive problems in the eurozone, it is no wonder more nations want to join – the requirement is just to appear prudent for a few years. No wonder also that it blew up. Nations with profligate governments or weak financial systems have a bonanza; overall, this system encourages a "race to the bottom" – led by governments in smaller countries, which relax fiscal and credit standards to win re-election (or just to enjoy a boom). They borrowed funds from the (unnaturally) less profligate in the eurozone. The Germans were austere; the periphery enjoyed the boom. Now we have moved past the boom, and someone in Greece, Portugal, Spain, Ireland and perhaps Italy has to repay something – or at least stop borrowing without constraint.

External financial support only makes sense if combined with reforms to eurozone incentives. But this weekend's actions jammed open the ECB credit window and send a clear message to creditors: you can again lend to the profligate without risk. Such emergency measures actually further undermine any government's willingness to address its solvency issues.

This can now go two ways: eurozone countries cede substantial sovereignty over fiscal policy (such as over budget deficits) and create a single strong bank regulator; or they let a system persist that creates another global "doomsday machine", perpetuating boom-bust-bailout cycles. In the first scenario, countries such as Greece eventually default. In the second, Europe further accumulates interconnected debt – until the eurozone more broadly "defaults", either through repudiation or inflation.

Peter Boone is an economist at the Centre for Economic Performance, London School of Economics and Principal, Salute Capital. Simon Johnson is a professor at the MIT Sloan School of Management and co-author of '13 Bankers: The Wall Street Takeover and the Next Financial Meltdown'