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Dogmatists raise the costs of eurozone crisis

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Published: May 16 2011 14:54 | Last updated: May 16 2011 14:54

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It is getting harder, politically. Finland and Germany have approved the bail-out of Portugal. But it is not clear whether both will vote in favour of the second Greek loan package, due this autumn. I still think they might, but it is not hard to imagine some political accident, in Berlin, in Athens, in Helsinki, in all three or somewhere else.

Pressure for a Greek default inside the eurozone is growing in Germany. Most policymakers and economists agree that Greek debt is not sustainable. Some commentators in British and US newspapers have even been advocating a Greek exit from the eurozone. The European Central Bank rejects both these suggestions. It even rejects a voluntary restructuring of debt. We are at a political impasse in the resolution of the Greek crisis. There is a little time left to take decisions, but the European Union is running out of options. So where next?

The original €110bn loan envisaged Greece returning to the capital markets in 2012. This is, of course, unrealistic. The next goal is to tide Greece over until 2013, when the new European stability mechanism (ESM) will kick in. That would require approximately another €50bn, but this supposes that the Greek economy turns the corner in 2012, and that the Greek government, in a triumph of hope over experience, can implement a much larger privatisation programme than it currently proposes. The new Greek loan programme will be much less than €50bn; my understanding is that it will be a little over €30bn, shared as usual between the EU and the International Monetary Fund.

The gap is to be financed by proceeds from privatisations. Another option would be collateralised loans issued by Greece. The idea is that the Greek government could issue bonds backed by state-owned assets, including assets earmarked for privatisation at a later date. There is a fundamental problem with collateralised lending, in that it would automatically subordinate existing creditors. But this is a debate of degree, not principle. The IMF tranche in the Greek credit programme is already super-senior. And the market prices for Greek debt securities already have much worse scenarios priced in.

From the perspective of a member of a national parliament, the real-world choice will not be whether they wish to bail out Greece or not. Of course, they do not. The choice will be between a costly bail-out and a costly default. Letting Greece default, whether inside or outside the eurozone, would require a fiscally crippling re-capitalisation of the European Central Bank, or a monetisation of Greek debt, and possibly more support for the financial system. A default may be inevitable at some point, but I doubt that it can, or should, happen before 2013 at the earliest.

Eurosceptic but risk-averse German or Finnish members of parliament might reluctantly vote in favour of a moderately sized rescue package, but a few things will still have to fall into place for that to happen. For example, there must be a plausible growth strategy for Greece. I doubt that MPs will vote for a loan package that relies on austerity alone. This has already failed. Any new package would have to focus on reforms in addition to continued austerity. For these reforms to work, they will have to be supported by the EU. And they will have to challenge powerful vested interests in the recipient countries. I would not rule out a token participation by the private sector, but there could be nothing resembling a debt restructuring.

Two big policy errors have aggravated the situation, both at the behest of Angela Merkel. The first was the German chancellor's promise that there would be no default on existing bonds until 2013, the second was the decision to rule out secondary market purchases by the ESM and, by extension, the current rescue umbrella as well. The combination of those two pledges logically implies that the EU has only a single policy tool at its disposal until 2013: continued bail-out linked to continued austerity.

It is not hard to foresee political resistance to such a strategy. My hunch is that Europe's policy elites will prevail, for a while at least, but the strategy is extremely risky, and dangerous, and prone to a large political accident.

The costs of crisis resolution could have been much lower if the German chancellor had sought better advice on the financial realities of the eurozone crisis. To satisfy the rule-based dogmatists in her party, Ms Merkel made promises she cannot conceivably deliver, a deceit that has already caught up with her. The dogmatists are now saying that Greece did not fulfil the conditions and that a new loan is thus unacceptable.

The one piece of good news from the eurozone is the exceptional growth performance of France and especially Germany during the first quarter of this year. But in terms of crisis resolution, this cuts two ways. It might increase the capacity and willingness of Germany and other northern European countries to help the periphery. But it might also lead to a much faster rise in interest rates, which would be a problem for Spain in particular.

I would still bet that the eurozone will muddle through this – defaulting eventually into a fiscal union with a common eurozone bond. It is either that, or a very messy break-up. **munchau@eurointelligence.com**