## The Greek Crisis and the Future of the Euro

In their Summit meeting a couple of weeks back, the euro zone's leaders declared that they would take "determined and co-ordinated action, if needed, to safeguard financial stability in the euro area as a whole." While good as a ringing policy declaration, it was short of any specific measures to help solve Greece's fiscal crisis. The financial markets were not very assured; the euro continued to remain weak; and the CDS spreads on Greek (and some other EU member) bonds remained stubbornly high. Greece itself is committed to bringing down the fiscal deficit from 12.7% of GDP last year to less than 3% by 2012; in 2010 alone the deficit is supposed to come down by as much as 4% of GDP!

Clearly, extremely onerous demands, perhaps more stringent than any country short of a major balance of payments crisis has faced, are being made on the Greek government to deliver on its promises. Mid-March, the European Union Finance Ministers would meet to review whether the steps taken are adequate to meet the 2010 target: a sharp tightening of the fiscal screw can only mean further slowdown in economic activity and an increase in unemployment which is already in double digits. In anticipation of wage cuts, public sector workers have resorted to industrial action.

For students of finance, the contrast between the benign neglect by the financial markets of California's fiscal woes, and the impact Greek problems are having, should be interesting. After all, California, as a percentage of the U.S. GDP, is more than 10%; Greece barely 2% of the euro zone. The difference arises from the fact that California is part of the United States of America, a sovereign nation, while Greece is a part of the euro zone with no central taxing authority. In many ways, monetary union in Europe was a very bold experiment, in the absence of a political union. The intellectual fathers of the euro recognized the weakness but hoped that the single currency would be a first step towards political union, their ultimate dream.

The Maastricht Treaty of December 1991, which committed EU members meeting the convergence criteria to a common currency, specifically provides that there can be no bailout of a member by the others. This provision does seem to constrain the ability of the larger euro zone economies like Germany and France, to lend to Greece: nor would voters like such a gesture. In fact, worried about exactly the kind of problem which Greece is facing, the Germans had insisted upon euro zone members entering into a stability pact limiting fiscal deficits to 3% of GDP, and debt as a percentage of GDP to 70%. As it happened, Germany itself was the first to breach the limit (in 2003), and thereby lost the moral authority to discipline other members. In the event, Greece not only breached the limit on fiscal deficit several times over, but its debt is more than 100% of GDP. One big worry for financial stability is that, in recent times, 60% of Greek debt has been placed with non-Greek EU banks, whose total exposure to Greek risks is a few hundred billion euros. The big test of Greek success in restoring market confidence will come in April and May, when it will need to raise fresh debt of € 20/25 bn.

Greece’s current account deficit is almost 15% of GDP. Obviously, were Greece to have an independent currency, the obvious actions would have been a devaluation and IMF loan. The latter may be needed even now, if only to reassure financial markets. Meanwhile, just as Prime Minister Harold Wilson of U.K. blamed the “Gnomes of Zurich” for Britain’s balance of payment problems in the 1960s, Prime Minister Papandreou is blaming “hegde funds are speculators” for Greece’s plight.

There are of course several question marks about the common currency in the light of the Greek crisis. Some of the more improtant ones are

⇒ Could the crisis spread to other coutnries like Portugal, Ireland and Spain whose finances are not in much better shape? (Spain’s unemployment is only a little short of 20%!) Alternatively, could it trigger moves towards a political union?

⇒ What about the long term future of the euro? Would other countries in central and eastern Europe, very keen to join the single currency, have second thoughts?

⇒ The euro’s status as a reserve currency?

⇒ How far would the problem in euro zone affect the global economy?

Answers to two other quesitons are perhaps clearer:

⇒ The incident would surely reduce the weight of the EU in global economic fora, firmly establishing the Big Two, namely the U.S. and China, as the leaders.

⇒ Greece once again emphasises the need for governments to keep a tight control on fiscal deficits. (At the time of finalising the article, I am not aware of our Finance Minister's proposals for fiscal 2010-11.)

But this apart, financial "innovations" allowed Greece to hide the true extent of its problems until recently; more on this next week.

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