The $ 1 trn package: less than meets the eye?

The earlier $ 150 bn eurozone/IMF package for Greece had not reassured the financial markets about the willingness of eurozone members to do all that may be necessary to restore Greek finances to a more stable level. There were also worries about whether the Greek disease would spread to other EU economies – Portugal? Spain? Ireland? The euro remained under pressure and the eurozone sovereign bond yields and CDS spreads did not soften.

The last Monday's much bigger $ 1 trillion (€ 750 bn) rescue fund jointly sponsored by the European Union and the IMF surprised the financial markets by its size and seemed to reassure investors of Europe's determination to put its house in order – at least initially. Global equity markets and the euro reacted positively. The mammoth fund was the result of a customarily long EU meeting over the week-end. Surely, the long term future of the euro and, indeed, the European Union itself must have played a role in the negotiations: after all, in a broader perspective, the EU leaders know how much Europe has gained through economic interdependence and integration – for the first time in more than two centuries, there has been no major conflict in Europe for the last 65 years, in no small measure due to European economic integration.

However, the markets' initial positive reaction seemed to undergo a change from the very next day. Global equity and bond markets turned jittery and the euro softened, as the details of the funding got analysed and the whole exercise seemed to amount to less than the first impression. The only actually committed amount is € 60 bn from an EU emergency fund; of the balance, € 440 bn would be raised in the bond market, as and when necessary to assist a member country, with the bonds guaranteed by the remaining eurozone members. And, these guarantees are going to need parliamentary approvals in these countries. The balance € 250 bn is to come from the IMF but its actual availability would depend on country-specific negotiations and conditionalities. The IMF contribution is more an expression of intent, and not a contractual commitment.

(Was not the IMF”s increase in resources agreed by the G20 meant for emerging/developing economies?) A more concrete move came from the European Central Bank which now stands willing to buy eurozone government bonds, without insisting on investment grade ratings.

While the package may well help in providing liquidity to countries facing problems, bigger issues remain: can democratic governments enforce the fall in living standards needed to restore some balance in the external account in the southern countries, and reduce dependence on capital inflows? Will the deflationary measures not increase unemployment and output at least temporarily, thus worsening the fiscal deficits and debt servicing problems? How will the financial markets react to any failures to meet fiscal targets? What about the impact of a possible double dip recession in the world’s largest economic bloc, namely the EU, on the global economy? Too many questions with no clear answers. One can perhaps be more certain in expecting that the euro’s status as the alternate reserve currency has clearly been damaged.

In the last week’s article, I had commented on the divide between the North and South within the eurozone as far as their current account balances are concerned. Is it a corollary of the cultural differences between the two groups? One can clearly see the cultural divide between the North (Austria, Germany, Netherlands, Scandinavian countries) and the South (Greece, Italy, Spain, Portugal, etc.), with France somewhere in between: the division between, on the one hand, the frugal, hardworking, Calvinist, better governed countries of the north with surpluses on current account; and, on the other, the spendthrift, less disciplined, fun loving, Catholic countries of the south, with deficits on the current account. The latter group of countries is also known for relatively poor governance, lax tax collections, etc. The political opposition in Germany to participating in the rescue package for Greece, was at least partly rooted in the cultural divide: why should the hard-working, honest German taxpayer bail out the lazy Greek? (Germany forgets that the deficits in the southern countries have created and sustained a lot of jobs and output growth in Germany.) The political opposition to the package in Germany remains strong as witnessed in the May 9th state election results. In any case, the provisions of various EU treaties have had to be interpreted with great flexibility and creativity before the package could be tied up: there are chances that it could be challenged in the German constitutional court.

The fact is that growth and capital inflows can hide a lot of sins – fiscal deficits, public sector wage increases unlinked to productivity, tax evasion, overvalued exchange rates, large deficits on current account, etc. -- for a while. But these are not sustainable. Surely, there are some lessons for India in the Greek tragedy – as also in the way credit default swaps triggered the crisis, a point I will come back to.

A.V.Rajwade
Email: avrajwade@gmail.com