Is the Euro Dead or about to Die?

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Let’s take a vote

Will the Euro be Dead before too long?

- Yes
- No
- Don’t know/uncertain

Economists' Search for Answer

- What are the benefits of keeping the Euro?
- What are the costs of keeping the Euro?
- Keep Euro if benefits are greater than Costs = economically rational decision
- Economic rationality may be trumped by Politics
- Only time will tell the victor – rationality or politics

Greece's Benefits of Keeping Euro

Avoid the costs arising when exit is discussed or imminent:

- Capital flight and bank troubles
- Recession, unemployment caused by uncertainties
  - What exchange rate for new drachma against Euro
  - Fights over size of haircuts given creditors
  - Possible court seizures of Greek assets abroad
  - Coming inflation and its effect on levels and distribution of incomes, social programs and taxation

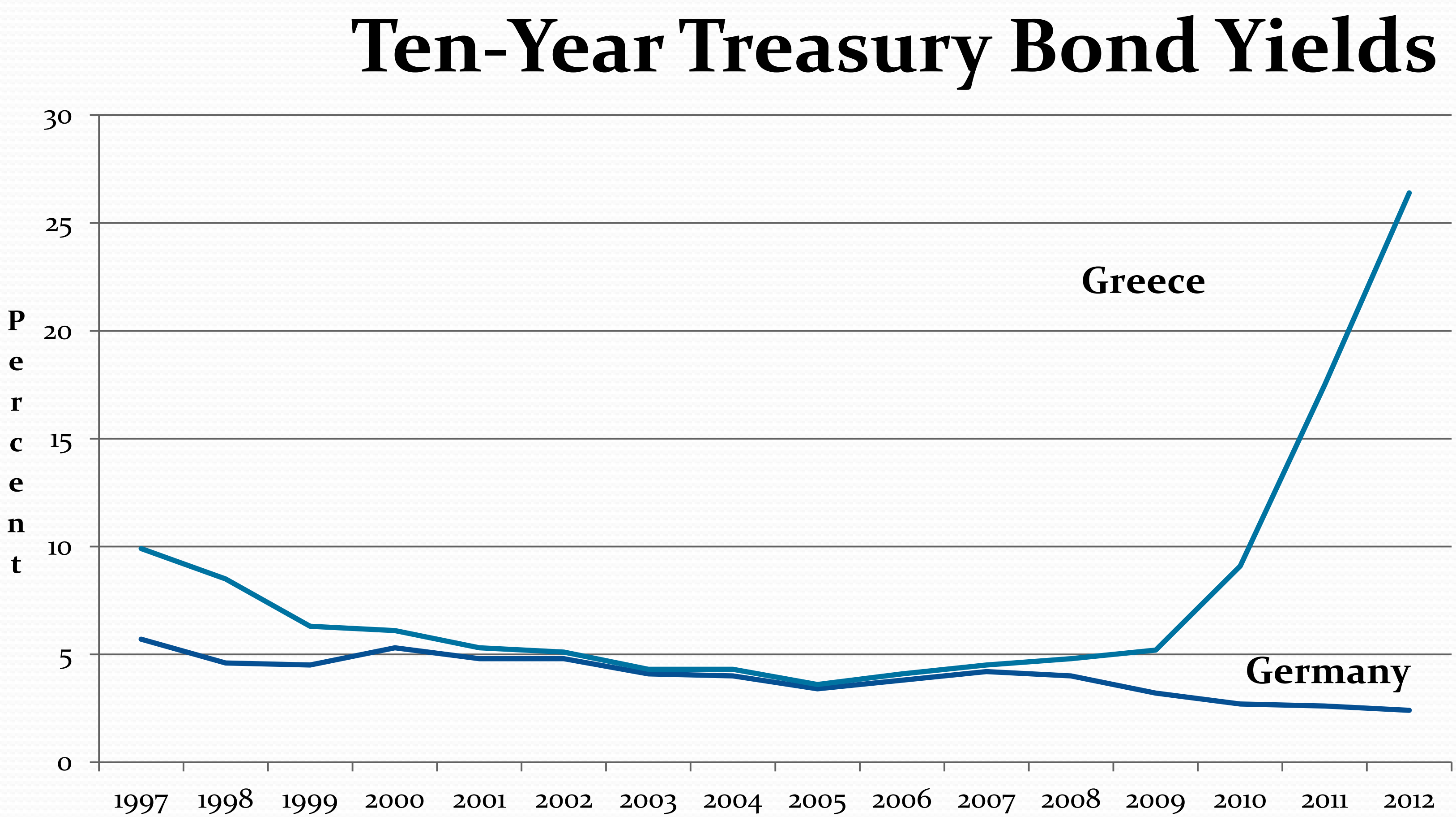
Greece's Benefits of Keeping Euro

Longer run:

Avoid traditional vote buying politics of

- Granting favours to interest groups (subsidies, tax concessions, regulation, public ownership and civil servant wages etc)
- Ordering Bank of Greece to print money to finance resulting deficits
- Resulting in political business cycles (inflation, devaluation, fiscal deficits)
- All avoided by not being to able to get European Central Bank to finance deficits
- Keep low interest rates due to elimination of currency risk (but not default risk)

Greek Interest Rates and the Euro



Other Euro Countries' Benefits

Avoid contamination of Spain, Italy, Portugal, Ireland, France (?), which would bring

- Capital flight and bank troubles in sending and receiving countries
- Lack of sufficient resources for bailout of these countries
- Risk of some other countries exiting Euro, ending entire Euro system

Other Euro Countries’ Benefits

By avoiding the end of the Euro system:

- Other Euro countries keep low interest rates
- The absence of exchange rate instabilities keeps low the costs of currency transactions and hedging, which increases trade, tourism and capital flows and thus productivity and incomes
- There is no return to traditional vote buying politics

Rest of the World Benefits

- The economies of all countries would suffer from turmoil and recession in Europe
- Benefit from preventing Greek exit
- Justification for involvement of IMF (and possibly USA, Britain) in rescue efforts
- IMF is involved, US and UK have own problems and refuse to provide funds

Controversy over Benefits

Some economists argue there are no such benefits because according to optimum currency area theory member countries and especially Greece lost from Euro-membership:

- Wrong industrial mix among different economies leading to different shocks and cycles, which need independent monetary and fiscal policies
- Countries have different history and culture (work ethic, honesty in dealings and data, welfare programs, tax systems, propensity to run deficits) result in different rates of inflation, trade imbalances and deficits, which need own monetary and exchange rate policies
- Motive for Euro was never economic but political – avoid European wars

Controversy over Benefits

Many other economists believe benefits exist

- Robert Mundell, “father of Euro” stressed
  - Savings from the elimination of currency markets
  - Exchange rate stability inducing
    - More trade and capital flows resulting in higher productivity
    - Removing monetary policy from national politics
- Frankel and Rose argue that optimum currency area criteria are endogenous to membership

The Cost of Saving Greece and Euro

- Financial assistance to avoid Greece's bankruptcy, which is conditional on progress with austerity measures and some reforms (privatization)
  - New practice of European Central Bank buying toxic bonds (equal to US Fed Quantitative Easing) to keep interest rates on Greek, Spanish, Italian bonds low
  - Creation of European Stability Mechanism to lend money to Greece to finance new deficits and roll over old debt
  - Involvement of IMF in lending to Greece

The Cost of Saving Greece and Euro

- Acceptance of haircuts (orderly write-downs of outstanding debt) by current private holders of Greek bonds at estimated rate of 75 percent. Official holders next? Total Greek bonds outstanding about $500 billion. Argentine's debt $81 billion; Lehman Brothers $530 billion; Enron $100 billion; GM $175 billion.

- Negotiations over direct assistance to banks in Greece and elsewhere in trouble over failed real estate loans within framework of Banking Union, common deposit insurance etc. (all at cost of Germany and other credit countries).

The Cost of Saving Greece and Euro

- Total Costs of these programs low, relative to capacity of other Euro countries and the size of the Greek economy = 2-3 percent of Euro GDP, size of Greater Miami

- Expectation that costs of financial aid will be reduced through repayment when Greek economy recovers (same idea as repayment of TARP loans to GM and Chrysler)

Rational Calculation

- **Benefits** of avoiding Greek bankruptcy and Euro exit are very high for Greece, other Euro countries and rest of world
- **Costs** of preventing Greek bankruptcy and Euro exit relatively low for other Euro countries and IMF
- Therefore, other Euro countries (and IMF) rationally should provide sufficient financial aid to Greece to prevent bankruptcy and Euro exit (with condition that proper austerity policies are adopted)

Views of Prominent Economists

- **Otmar Issing** – former head of Bundesbank, first head of European Central Bank, Professor of Economics, Goethe University Frankfurt:

"Based on rational benefit/cost calculations, odds favour Euro survival"

- **Martin Feldstein**, Harvard Economist, Chair of Economic Advisors under President Reagan, long head of National Bureau for Economic Research:

Long opponent of Euro, now supports retention because abandonment is too expensive

Rationality vs Politics

- **Bad news**
  - In Greece government is VERY reluctant to adopt austerity measures and needed reforms because of:
    - Rise of populist parties in Greece
    - Public demonstrations and riots egged on by politicians
  - Increasing opposition to bailouts in Germany, Finland
  - Austerity causes recessions and extends time needed to balance budgets

Rationality vs Politics

Bad News: Pervasive Need for Reforms

- One half of Piraeus Harbor run by Chinese COSCO (in 2010 paid $647 million to government for privilege)
- Some workers' in Greek half of harbor have salaries that reach $181,000 a year with overtime; Cosco is typically paying less than $23,000.
- Gantry cranes in the Greek part require the use of 9 workers (union rules); Cosco cranes are operated by four workers.
- Source: Financial Post, October 12, 2012, FP3

Rationality vs Politics

Bad News: Pervasiveness of Problems

- Tax collectors: story of Toyota manager
- Religious institutions: Story of real estate lease in Italy

Rationality vs Politics

- **Good news**
  - Technocrats appointed Prime Ministers in Greece, Spain and Italy to make needed but unpopular austerity measures
  - Parliaments in Italy and Spain have enacted strong austerity measures in spite of demonstrations
  - Pro Euro parties won elections in Greece, Netherlands
  - German supreme court called subsidies constitutional

Prevent Future Problems

- Private capital markets had been expected to prevent Greek deficits and debt
- Why did they not do their job?
- Answer is important to prevent future problems like Greece

Prevent Future Problems

Normal capital market responses to chronic deficits:

- Credit rating agencies downgrade government bonds, resulting in:
  - Higher borrowing costs
  - Interest payments eat up ever increasing share of tax revenue
  - Governments respond by eliminating deficits
- Why did credit rating agencies fail to their job with Greece?
- Why did private lenders fail recognize Greek problems and demand higher interest rates?

Lying with Statistics

Michael Lewis in *Boomerang* (Greek Minister of Finance George Papaconstantinou in quotation marks):

"The second day on the job I had to call a meeting to look at the budget. I gathered everyone from the general accounting office, and we started, like, this discovery process."

Each day they discovered some incredible omission. A pension debt of billion dollars every year somehow remained off the government's books, where everyone pretended it did not exist, even though the government paid it; the hole in the pensions plan for the self-employed was not the 300 million Euros they had assumed but 1.1 billion Euros; and so on.

Lying with Statistics

Continued quotation from Lewis:

"At the end of each day I would say, 'Okay, guys, is this all?' And they would say, 'Yeah.' The next morning there would be this little hand rising in the back of the room: 'Actually, Minister, there's this other one-hundred-to-two-hundred-million-euro gap.' This went on for a week." (p.7,8)

The Greek government had estimated its 2009 budget deficit at 3.7 percent. Two weeks later that number was revised upward, to 12.5 percent, and actually turned out to be nearly 14 percent.

Lying with Statistics

More quotations from Lewis, this one referring to an interview with Miranda Xafa, former assistant to the Greek Prime Minister, Director of the IMF and economist with Salomon Brothers:

…she pointed out in 1998 that if you added up all the Greek budget deficits over the previous fifteen years they amounted to only half the Greek debt. That is, the amount of money the Greek government had borrowed to fund its operations was twice its declared shortfalls.

Xafa quote: 'At Salomon we used to call [the then head of the Greek National Statistical Service] 'the Magician' because of his ability to magically make inflation, the deficit and the debt disappear.'

Lying with Statistics?

Xafa at conference in Italy:

Greek statistics are not lying but involve creative book keeping. For example

International accounting rules allow payments to Greek Railroad to be considered investment and therefore not deficit-creating spending. The problem was that the money going to the railroad was used to finance the organizations current deficits, not an investment.

The Role of Financial Institutions

Private financial institutions helped Greek misrepresentations:

- Created bonds on which interest is paid out of future Greek government lottery profits; some out of future subsidies received by Greece from European Community in Brussels for the maintenance of monuments from antiquity.
- The proceeds from the sale of these bonds to private buyers, after a hefty fee, went to the Greek government, which promptly spent the money to reduce reported current deficits.

Puzzles

- Credit rating agencies and international organizations reporting Greek statistics failed to do due diligence and verify data.
- Private buyers of bonds knew about misleading data but still bought Greek bonds at low interest rates.
- Why?

Answers to Puzzles

- Expectation that Euro zone countries would bail out Greece (rational calculus?)
- Nearly one trillion dollars of security purchases by sovereign wealth funds ensuring demand for bonds
- Overall euphoria about new era of financial and economic growth which also supported
  - US Housing Boom
  - Securitization of Mortgages
  - All kinds of derivatives
  - Credit swaps (insurance against defaults)

Lessons for Future

Otmar Issing:

- Restore traditional role of financial markets.
- Do not rely on
  - Fiscal Union and collective approval of national budgets
  - The issue of European Union sponsored bonds, which transfers proceeds to countries running deficits
  - Balanced budget legislation
  - Too political and technically difficult to administer

Hopeful Signs

- Credit rating agencies are doing their job
- Private lenders have become properly cautious
- Collective solutions are held up and may not pass

Summary and Conclusion

- The future of Euro involves complex issues
- Don’t blame economists for reluctance to predict outcome of political processes
- Economists “sort out the issues”, have no crystal ball

Another Vote?

After exposure to my efforts to sort out the issues, raise hand if you:

- Have changed your predictions about the death of the Euro
- Retained opinion held at start of discussion