Greece and the Euro: Towards Financial Implosion

By Prof Rodrigue Tremblay
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*This incisive article by **Professor Rodrigue Tremblay** (image right) on the nature of the Greek economic crisis was written four years ago.*

In response to recent developments, the author has written an update, which is published below.

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July 6, 2015

The EU Sows the Seeds of the Greek Economic Crisis

Prof. Rodrigue Tremblay

Update to July 2011 article entitled Greece and the Euro: Towards Financial Implosion

(scroll own for the July 2011 article)

In sowing the seeds of the Greek crisis, European politicians have made the same mistakes as American politicians before the financial and banking crisis of 2008-09, that is to say encourage excessive indebtedness of some economically weak countries with loan guarantees.

What really created the conditions for a major financial and banking crisis in the U.S., starting in 1999 when the so-called Glass-Steagall Act of 1933 was abolished by the administration of Bill Clinton, was the innovation of insurance given to risky loans.

In the U.S., the regulatory agencies that are the U.S. Treasury (controlled by mega banks)

and the central bank (the Fed) (controlled by mega banks) closed their eyes when risky banking products were created, not the least being the famous derivative products such as the mortgage-backed CDOs (collateralized debt obligations) whose risk of default was artificially reduced with insurance contracts (the famous Credit Default Swaps or CDS) against payment default and issued by large insurance companies such as AIG (American International Group). In doing so, borrowing was greatly encouraged and bank lending became more risky. It resulted in a mountain of mortgage debt, which led to the creation of a speculative housing bubble that began collapsing in 2005, and which turned into a general global financial crisis in 2008-09.

However, European politicians seem to have made the same mistake as American politicians. In their case, they encouraged a rise in the public debt of the poorest countries in the Eurozone by giving guarantees against default to large banks if they continued lending to them despite growing risks. This is what enabled a government like the Greece government, for example, to continue piling on debt upon debt even though lenders would have by themselves stopped lending, if they had not received guarantees against default. Today, the Greek debt represents an unsustainable 177 percent of its annual GDP (yearly total domestic production). Indeed, when a country's debt exceeds 100 percent of its gross domestic product (GDP), creditors begin to get nervous. They react normally by raising interest rates and by reducing the volume of their loans.

But in Europe, politicians wished to keep interest rates as low as possible on loans to the most economically weak countries of the Eurozone. In doing so, they created, in 2010, the European Financial Stability Facility (EFSF), with guarantees from member States, in proportion to their participation in the European Central Bank (ECB). At a minimum, the EFSF has secured 131 billion Euros of Greek debt. Thus German taxpayers, for example, are on the hook for 41.3 billion Euros of guaranteed Greek debt, while French taxpayers, through their government, are responsible for 31 billion Euros of that debt, and so on for the other 17 member countries of the Eurozone. In so doing, an economic debt problem has been transformed into a major political issue.

Now, European politicians who gave a public guarantee to a large part of the Greek debt fear the political consequences if they were to pass the buck of the Greek government's default on its debt to their own taxpayers. On the other hand, large banks and other lenders, confident in the guarantees they obtained from other European governments, feel no inclination to 'restructure' down the Greek government's debt. In other words, everything is frozen. In a normal situation, creditors would bear alone the risks undertaken in lending to a government already deeply in debt, and they would have to write off some of the bad debt on the books.

This is reminiscent of the American situation before the 2008-09 financial crisis when mortgage lenders would not accept to reduce the mortgage debts of borrowers because their claims had been secured against default by insurance contracts to that effect. We know how it was resolved. American taxpayers were called to the rescue of mega banks and mega insurance companies, either directly through the U.S. Treasury or indirectly through the central bank (Fed), the latter acquiring from the banks toxic assets at full price. The same scenario is likely to occur in the Eurozone, whether Greece remains or not in the monetary union. In that sense, last Sunday's Greek referendum on July 5 did not change anything.

In the Greek case, it has to be remembered that international investment banks, especially

Goldman Sachs, used derivatives and dubious accounting tricks to camouflage the extent of the Greek government's debt in order to meet the strict requirements to join the Eurozone and allow Greece to join the monetary union. The main criteria to join the Eurozone are a public deficit below 3% of GDP and a public debt level lower than 60 % of GDP.

It is on these last two criteria that Goldman Sachs assisted the Greek government, in 2001, in presenting a rosy and false financial picture of its real deficit and its real debt level. Why European banking authorities allowed themselves to be lured by these tricks is another matter that should one day be clarified.

Rodrigue Tremblay, Montreal, July 6, 2015

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> "If you can't explain it simply, you don't understand it well enough."
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> Albert Einstein (1879-1955), German-born theoretical physicist and professor, Nobel Prize 1921

> "It is incumbent on every generation to pay its own debts as it goes. A principle which if acted on would save one-half the wars of the world."
>
> Thomas Jefferson (1743-1826), 3rd President of the United States (1801-09)

> "Having seen the people of all other nations bowed down to the earth under the wars and prodigalities of their rulers, I have cherished their opposites, peace, economy, and riddance of public debt, believing that these were the high road to public as well as private prosperity and happiness."
>
> Thomas Jefferson (1743-1826), 3rd President of the United States (1801-09)

On the 4th of July, the credit agency Standard & Poor called Greece what it is, i.e. a country in *de facto* financial bankruptcy. No slight of hand, no obfuscation, no debt reorganization and no "innovative" bailouts can hide the fact that the defective rules of the 17-member Eurozone have allowed some of its members to succumb to the siren calls of excessive and unproductive indebtedness, to be followed by a default on debt payments accompanied by crushingly higher borrowing costs.

Greece (11 million inhabitants), in fact, has abused the credibility that came with its membership in the Eurozone. In 2004, for instance, the Greek Government embarked upon a massive spending spree to host the 2004 Summer Olympic Games, which cost 7 billion euros ($12.08 billion). Then, from 2005 to 2008, the same government decided to go on a spending spree, this time purchasing all types of armaments that it hardly needed from foreign suppliers. —Piling up a gross foreign debt to the tune of $533 billion (2010) seemed the easy way out. But sooner or later, the piper has to be paid and the debt burden cannot

be hidden anymore.

Greece's current financial predicaments (and those of other European countries such as Spain, Portugal, Ireland and even Italy) are not dissimilar to the ones Argentina had to go through some ten years ago. In each case, an unhealthy membership in a monetary union of some sort led to excessive foreign indebtedness, followed by a capital flight and a crushing and ruinous debt deflation.

In the case of Argentina, the country had decided to adopt the U.S. dollar as its currency, even though productivity levels in Argentina were one third those in the United States. An artificially pegged exchange rate of one peso=one U.S. dollar held for close to ten years, before the inevitable collapse.

Indeed, membership in a monetary union and the adoption of a common currency for a group of countries can be a powerful instrument to stimulate economic and productivity growth, with low inflation, when such monetary unions are well designed structurally, but they can also turn into an economic nightmare when they are not.

Unfortunately for many poorer European members of the euro monetary union, the rules for a viable monetary union were not followed, and its unraveling in the coming years, although deplorable, should be of no great surprise to anyone knowledgeable in international finance.

What are these rules for a viable and stable monetary union with a common currency?

> 1- First and foremost, member countries should have economic structures and labor productivity levels that are comparable, in order for the common currency not to appear persistently overvalued or persistently undervalued depending on any particular member economy. An alternative is to have a high degree of labor mobility between regional economies so that unemployment levels do not remain unduly high in the least competitive regions.
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> 2- Secondly, if either one of the two above conditions is not met (as is usually the case, since real life monetary unions are rarely "Optimum Currency Areas"), the monetary union must be headed by a strong political entity, possibly a federal system of government, that is capable of smoothly transferring fiscal funds from surplus economies to deficit economies through some form of centrally managed fiscal equalization payments.
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> This is to avoid the political strains and uncertainty when the standards of living rise in surplus regional economies and drop in regional deficit economies. Indeed, since the regional exchange rates cannot be adjusted upward or downward to redress each member country's balance of payments, and since the law of one price applies all over the monetary zone, this leaves fluctuations in income levels and employment levels as the main mechanism of adjustment to external imbalances. —This can turn out to be a harsh remedy.
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> Indeed, such a system of income or quantity adjustment rather than price adjustment is somewhat reminiscent of the way the 19th century gold standard used to work, albeit with a deflationary bias, except that it was expected to have price and income inflation in surplus countries and price and income deflation in deficit countries, caused by money supply expansions in surplus economies and money supply contractions in

deficit economies. In a more or less formal monetary union, we are left with income inflation and deflation while the central bank holds the rein on the overall price level.

3- A third condition for a smoothly functioning monetary union is to have free movements of financial and banking capital within the zone. This is to insure that interest rates are coherent within the monetary zone, adjusted for a risk factor, and that productive projects have access to finance wherever they take place.

In the U.S., for instance, the highly liquid federal funds market allows banks in temporary deficit in check clearing to borrow short-term funds from banks in a temporary surplus position. In Canada, large national banks have branches in all provinces and can easily transfer funds from surplus branches to deficit branches without affecting their credit or lending operations.

4- A fourth condition is to have a common central bank that can take account not only of inflation levels but also of real economic growth and employment levels in its monetary policy decisions. Such a central bank should be able to act as lender of last resort, not only to banks, but also to the governments of the zone.

Unfortunately for the Eurozone, it currently fails to meet some of the most fundamental conditions for a smoothly functioning monetary union.

Let’s look at them one by one.

-First, labor productivity levels (production per hour worked) vary substantially between the member states. For example, in 2009, if the index of productivity level in Germany was 100, it was only 64.4 in Greece, nearly one third lower. In Portugal and Estonia, for instance, it was even lower at 58 and 47 respectively. What this means is that the euro, as a common currency, may appear undervalued for Germany but overvalued for many other members of the Eurozone, stimulating net exports in the first case but hurting badly the competitiveness of other member countries.

-Secondly, and possibly an even more important requirement, the Eurozone lacks the backing of a strong and stable political and fiscal union. This leaves fiscal transfers between member states to be left to *ad hoc* political decisions, and this creates uncertainty. In fact, there are no permanent mechanisms of equalization payments between strong and weak economies within the Eurozone. —For this reason, we can say that there is no permanent economic solidarity within the Eurozone.

-Thirdly, the designers of the Eurozone elected to limit the European Central Bank to a narrowly defined monetary role, its central obligation being to maintain price stability, while denying it any direct responsibility in stabilizing the overall macroeconomy of the zone and preventing it from lending directly to governments through money creation, if needs be. —For this reason, we can say that there is no statutory financial solidarity within the Eurozone.

Finally, even though capital and labor mobility within the Eurozone is fairly high, historically speaking, it is far less secured, for instance, than it is the case with the American monetary union.

In retrospect, it seems that the creation of the Eurozone in 1999 was more a political gamble than a well-thought-out economic and monetary project. This is most unfortunate,

because once the most estranged members of the zone begin defaulting on their debts and possibly revert to their own national currencies, the financial shock will have real economic consequences, not only in Europe, but around the world.

Many economists think that the best option for Greece and the rest of the EU should be to engineer an "orderly default" on Greece's public debt which would allow Athens to withdraw simultaneously from the Eurozone and to reintroduce its national currency, the drachma, at a debased rate. This would avoid a prolonged economic depression in Greece.

Refusing to accept the obvious, i.e. an orderly default, would please Greece's banking creditors but will badly hurt its economy, its workers and its citizens. That's what bankruptcy laws are for, i.e. to liberate debtors from impossible-to-repay debts.

Of course, the most debt-ridden nation on earth is not Greece, but the United States.

Let me say this as a conclusion: If American politicians do not stop playing political games with the economy, a lot of Americans are going to suffer in the coming months and years, and this will spill over to other countries.

With Europe and the United States both in an economic turmoil, this is very bad news for the world economy.

Dr. Rodrigue Tremblay *is a professor of economics (emeritus) at the University of Montreal and a former Minister of Trade and Industry in the Quebec government. He is the author of "The Code for Global Ethics, Ten Humanist Principles",*

Please visit the book site at: TheCodeForGlobalEthics.com/

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