Difficult Risk – Risk Tradeoffs: Political vs. Financial Risk in the EU

William Leiss (12 August 2011)

There was an important article by Jack Ewing and Liz Alderman in the August 10 edition of *The New York Times,* entitled "Some in Germany want Greece to temporarily exit the Euro Zone." This article takes up issues that have been quietly heating up in the background for some time already but which are, inevitably, becoming harder to ignore. Ever since the first EU bailout of Greece in May 2010, and intensifying with the subsequent Portuguese rescue mission and especially the second Greek one, both in 2011, comments emanating from Germany and elsewhere have cast aspersions on the "profligate southerners" who have come to depend on their "frugal" northern compatriots to rescue them from financial disasters of their own making.

The Greek case is odious, because there was a deliberate effort on the part of its officials and politicians, over many years, to deceive their fellow EU members about the size of their budgetary deficits and sovereign debt levels. But everyone in the EU's governing circles shares the blame, since theirs was a collective failure, first, to think carefully about the risks of creating a monetary union without a fiscal union, and second, to put in place rigorous reporting requirements and auditing measures to establish reliable figures on financial data. In the end, to be sure, the greatest burden of responsibility falls on the Greek politicians, interest groups, and public at large, all of whom allowed their nation's sovereign debt to grow from a relatively modest level, thirty years ago, to the unsupportable heights it has now reached (€333 billion and counting, well before the second EU bailout tranche has been delivered).

A number of commentators are on record as saying that Greece cannot possibly repay this amount of debt in full and that, sooner or later, it must leave the Euro Zone and default – see, e.g., Nouriel Roubini in mid-June [http://tinyurl.com/63vlbuo]. Default means that its sovereign bonds would collapse in value, probably by 50% or more, producing large losses for the bondholders. All of Greece's banks, which hold €30b of this debt, would collapse, and the country would be plunged into a deep and long-lasting recession with massive unemployment. More than half of this debt is now in the hands of public entities outside Greece (IMF, national governments, the ECB and national banks in Europe), and an additional €50b is in the hands of private-sector banks in Europe, mainly German and French; and under current conditions, as Greek bonds mature (€100b by 2014), a higher proportion of the total will be held by public sector entities. [http://www.economist.com/blogs/freeexchange/2011/06/greek-debt]. Since we all know by now that governments will bail out their large banks, this means that European taxpayers could take losses of €100-150b or more.

Default would mean, of course, severing Greece from the Euro Zone and restoring its former national currency, which would undoubtedly be a very painful process. And yet, in such matters, if default is inevitable, sooner is much better than later, since it enables countries to put the difficulty behind them and begin the long path back to recovery. For the Greeks themselves, this could be preferable to enduring years of watching a steady downward spiral in their economy, putting them ever further from being able to start running government surpluses and paying down their debt, before finally defaulting and hitting bottom anyway. And even for the Europeans this could make sense, because they could then apply the €60b already committed to the second bailout against their expected current losses on the bond defaults – and because, if they do not consider this option, almost certainly they will be in for a third bailout after 2014, throwing even more good money after bad, after which – who knows?

Another important reason for thinking through this alternative scenario with respect to the EU's collective financial risk is that it could set a precedent to seal off the prospect of catastrophic levels of increasing collective debt as further bailouts are required, for Portugal or Ireland (again) or, more ominously, for Spain and Italy. In every case this would mean shrinking the Euro Zone and restoring older national currencies. Of course, eventually, one could bring them back into the currency union – but, this time, with a proper fiscal union solidly in place, and with a common debt held in Eurobonds.

Finally, this radical and bitter financial medicine might be what is needed to head off a potentially surging political risk within Europe. This is the risk vs. risk scenario whereby the ongoing bailout sagas gradually give rise to political anger in the northern European countries which are shouldering the burden of responsibility (and which, in the case of France, just this week, are starting to feel the resulting pressures in their own financial markets). These sentiments are already on the rise in smaller nations such as Finland and Denmark, but most importantly, in Germany, the main EU backstop. If the costs of bailouts keep rising, and if both France and Germany feel directly some sustained financial market pressures related to their prominent roles in the European Financial Stability Facility and the European Central Bank, then it is almost inevitable that the taxpayers in these nations would rebel at some point.

Europe paid an enormous price in the twentieth century, twice over, for political antagonism among its member states. It cannot afford to ignore this new political risk, because such trends sometimes suddenly spiral out of control and politicians become unable to stop this type of downward spiral. It was rather ominous to read in the Ewing and Alderman article that some Greeks, stung by the pointed criticism of their financial imprudence originating in Germany, recalled that Germany had never paid reparations to Greece following the cruel Nazi occupation of their country.

There are of course downsides to every risky scenario, even for the stronger members of the EU. If some of the weaker economies in the southern belt are removed from the Euro Zone, the euro will rise in value. For export-driven Germany this will make its products more expensive on world markets, just when the second round of recession gets under way. Almost certainly the keen awareness of this fact on the part of senior German officials and politicians, including Chancellor Merkel, is moderating their political discourse. But these are the types of trade-offs that are very difficult for citizens to come to terms with: a sophisticated understanding of the determinants of the euro's exchange rate does not have anywhere near the emotional impact of the urge to "punish" the perceived malingerers in the south. Changes in popular attitudes can very quickly eliminate the discretionary room for manoeuvre available to politicians.

There are huge stakes involved in these issues. But it may be that the riskiest scenario of all is just trying to ignore them in the hope they will fade away of their own accord.