Insight

Greece, Europe and Financial Markets

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The events of the past several days have raised lots of questions. Here are a few answers with few numbers to get in the way:

What is the problem?

Greece has issued a large amount of debt. Even worse, looking ahead it has an enormous gap between planned spending and planned revenues. As a result, it is becoming increasingly less likely that it could (a) rollover the existing debt and (b) borrow additional amounts to cover the future deficits.

o Prices of existing Greek debt will fall, reflecting the possibility that Greece will be unable to pay it off in full.

o Interest costs on new debt will rise, reflecting the up-front compensation that lenders demand against the chance of default.

Greek wages and costs are too high for its products to compete. It can either deflate, or allow its exchange rate to depreciate. Greece cannot depreciate because it is tied to the euro. Accordingly, its ability to pay for its future spending is even more in doubt.

European banks hold large amounts of Greek debt. Thus, its falling value hurts them, raising the prospect of economic weakness across the entire Eurozone.

Portugal, Italy, Ireland, and Spain have problems similar to Greece and are larger. If investors begin to draw the same conclusions about their futures as they are for Greece, all of the problems magnify.

If investors panic about all sovereign borrowers with large debt and deficits (UK, U.S.), or their creditors, we re-create the conditions in which a sub-prime crisis morphed into a global financial crisis.

How could it affect the United States?

A weak European economy could hurt U.S. exports.

A European banking crisis could damage U.S. financial firms if they own enough of their debt. At present, this appears to be limited.

A crisis regarding multiple countries may affect investors' appetite for risk:

o One would expect that a flight to safety would lower Treasury borrowing rates. This might be mildly beneficial.

o Stocks and other risky investments would fall, reducing household wealth and the willingness of firms to hire and expand.

A full-blown financial crisis repeats the experience of 2008 and 2009. However, because the U.S. has greater ability to raise taxes and cut spending to address a crisis, investors are unlikely to lose faith in Treasury debt at this time.

What does the EU bailout do?

The bailout came in two pieces:

About 750 billion euros were pledged by European governments and the International Monetary Fund (IMF).

o The Europeans are treating this as a liquidity crisis, where the fundamentals are sound and sufficient “shock and awe” can scare away speculators.

o Private analysts mostly believe this is a solvency crisis. In the absence of any structural changes to the Greek tax code, spending programs, and prospects for economic competitiveness and growth, this does nothing to change the Greek outlook.

o If nothing changes, the money will be used to pay off existing debt as Greece continues to borrow. Eventually the money runs out and all that is accomplished is a transfer of taxpayer dollars to creditors.

o All of this happens faster if Portugal and Spain come under suspicion.

o The bailout package contravenes the common understanding of Europe’s founding documents (which forbid bailouts) and rewrites the European compact. It is already very unpopular in Germany and likely to become more so as it becomes clear how taxpayer dollars are transferred to creditors.

o Bottom line: the hope is that the cash will buy Greece time, avoid investor nervousness about Portugal and Spain, keep banks healthy and lending, and that reforms and growth may alleviate the debt concerns.

The European Central Bank (ECB) committed to directly purchase the debt of Greece and perhaps others.

o This is a big deal. It is equivalent to the Fed’s dramatic purchases of Treasuries, mortgage-backed securities, and other instruments during the crisis.

o It represents aggressive monetary easing aimed at undergirding economic growth.

o But it carries with it a perceived loss in independence because it is stepping in to fix a fiscal mess (not its job) at the risk of higher inflation (its only mandate). It also threatens to realize many Germans’ biggest fear: that they gave up their strong Deutsche Mark in exchange for a currency that will be weakened by inflation.

Will it work?

Nothing in the protests in Greece, the political landscape in Spain and Portugal, or even the British elections suggests a willingness to undertake the tough reforms needed to make this work.

It will buy some time, but the unraveling of Greece and perhaps others will likely raise the chances that strong members like Germany eventually walk away from the euro.