Five Minutes to Midnight in Athens

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Events are rapidly coming to a head in Greece, and the consequences could ripple through all of Europe.

Leading Greek economists and bankers yesterday warned George Papandreou, prime minister, that he had to announce bold initiatives to rescue the country's collapsing bond market and avert the possibility of defaulting on a rising public debt.
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Yannis Stournaras, an Athens University economics professor and former chief adviser at the finance ministry, said: "Other countries in trouble have already taken measures. If we don't quickly follow suit the adjustment will be imposed by markets and it will be violent."

How violent? Maybe not as violent as the protests in the streets of Athens. Already there are student, pensioner, and public worker protests and strikes. Remember that the current government is only two-months old, after the old government nearly collapsed under the pressure from street riots.
This puts the current government in an extremely difficult situation. The public debt is set to rise next year to 124 per cent of GDP, with a fiscal deficit of over 12%. Meanwhile, the public pension fund is expected to go into the red as early as 2011. The fiscal squeeze requires draconian cuts, but the public workers of Greece are not a wealthy group. They will have no choice but to turn out into the streets en mass.
Premier George Papandreou recognizes that.

"Salaried workers will not pay for this situation: we will not proceed with wage freezes or cuts. We did not come to power to tear down the social state," he said.

On the other side are the foreign creditors, and they don't care about Greece's internal problems.

“It’s five minutes to midnight for Greece,” Buiter, who will join Citigroup Inc. as its chief economist next month, said in a Bloomberg Television interview today. “We could see our first EU 15 sovereign default since Germany had it in 1948.”

The bond markets are looking at a combination of spending cuts and higher taxes totaling at least 7% of GDP - an amount so high that it would cause Greece's recession to become a depression, and would ultimately lead to the collapse of the government.
What foreign creditors are expecting is Greece to go to the IMF and the European Commission for bailouts. Those bailouts are likely, but at a steep price. The IMF and EU would almost certainly require an austerity program much like Latvia recently was. However, those austerity programs frequently solve nothing. Latvia, for example, is poised to fall back into an economic crisis despite slashing public salaries and closing almost all of its hospitals. The Ukraine is another nation that the IMF bailouts have failed to fix.
For half a century, the IMF's solution has caused a deflationary spiral more often than not.

Greece's situation is compounded by being a European Monetary Union member. This prevents it from using a monetary solution to its debt problems, like quantitative easing or devaluing its currency. However, EMU membership doesn't have to be forever.

Greece and Ireland are among countries in an “intolerable” economic situation, which may lead to bailouts or even an exit from the euro area by the end of next year, according to Standard Bank Plc.
“Countries like Ireland and Greece may not be able to grow out of the current crisis,” Barrow said in a telephone interview today. “With interest-rate cuts, exchange-rate depreciation and significant fiscal support all off limits for these countries, bailouts or even pullouts from EMU may happen next year.”

A Greek exit from the EMU would be drastic, and would have serious risks for Greece. It would cause a drastic currency fall and price inflation. On the other hand, the risks would be shared.

Greek exit from EMU would be dangerous. Quite apart from the instant contagion effects across Club Med and Eastern Europe, it would puncture the aura of manifest destiny that has driven EU integration for half a century.
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No doubt, EU institutions will rustle up a rescue. RBS says action by the European Central Bank may be "days away". While the ECB may not bail out states, it may buy Greek bonds in the open market. EU states may club together to keep Greece afloat with loans for a while. That solves nothing. It increases Greece's debt, drawing out the agony. What Greece needs – unless it leaves EMU – is a permanent subsidy from the North. Spain and Portugal will need help too.

Eventually the bond holders are going to have to suffer a haircut, just as they did when Argentina defaulted. While it caused immense short-term pain, it cleaned the bad debt out of the system and didn't cause the long-term armageddon that was predicted by the bond market.

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