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ANALYSIS

Medicine for Europe's Sinking South

By Nouriel Roubini and Arnab Das
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Editors Note - This Financial Times Op-Ed is drawn from a more extensive piece of research, How to Avoid a Greek Tragedy in Europe, provided earlier this week to RGE's clients.

Another Great Depression may have been averted but the crisis is far from over. Credit is tight and contagion is spreading to all highly leveraged points in the global economy: mortgage-ridden households (Iceland, the US, the UK, Spain, Ireland, central and eastern Europe); banks (Iceland, the US, the EU, Russia and the former Soviet Union); quasi-sovereign debt (Ukraine's Naftogaz, Dubai World); and now Greece and other weak links in the eurozone.

Greece has long been an accident waiting to happen due to heavy public debt and lack of competitiveness. But its problems are not unique. On their resolution rides the fate of its neighbours, the eurozone and perhaps the European Union itself.

Fiscal incontinence and uncompetitiveness are interlinked across southern Europe. Euro accession and bull-market "convergence trades" pushed the bond yields of Portugal, Italy, Greece and Spain towards German bunds. The ensuing credit boom supported consumption but papered over wage inflation that outstripped productivity growth and priced Greece out of traditional export markets.

Excessive bureaucracy and rigidities in labour, product and service markets, meanwhile, discouraged investment in high value added sectors, despite wages well below the EU average. The resulting noxious mix of large current account and budget deficits led to rising foreign debt. Dramatic euro appreciation in 2008-09 compounded these problems.

As bond yields rise, Greece and its peers face difficult choices. The best course would be to follow Ireland, Hungary and Latvia with a credible fiscal plan heavy on spending cuts that government can control, rather than tax hikes and loophole closures that depend on historically weak compliance. This could achieve an internal devaluation with deep real wage cuts and structural reforms to boost competitiveness, as Germany has since unification.

The easy option would be to resort to financial engineering and fiscal fudges, delaying adjustment. In this scenario market access would eventually be lost, perhaps by mid-2010. Greece would then have to turn to other member states for direct loans (denied – at least so far); to the International Monetary Fund (ruled out – so far); or to non-traditional creditors, say China (denied). Alternatively, it could devalue, default and re-denominate liabilities into a "new drachma," à la Argentina (unthinkable).

A credible austerity plan would restore solidarity with EU countries that are adjusting, improve the rhetoric of the European Central Bank and key member states, and bring Greek bond spreads back to earth. This approach is working in Ireland – spreads exploded as public debt ballooned to save its banks, but came back in as public spending was cut by 20 per cent. But it is no cakewalk: Portugal has been deflating to

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boost competitiveness for a decade. Harsh medicine is best ingested quickly.

Greece's adjustment would ideally be backed by a large IMF programme to prevent a run on public debt and banks during the tough times ahead. In a Europe-only plan, the European Commission would monitor adjustment and the ECB would lend. Neither has imposed conditionality on members, which is what the IMF does for a living. The IMF is ruled out because it would signal weakness. But an EU-only plan may be seen as a fudge by interested parties, given the risks to Europe of failure.

Failure to take the tough decisions necessary would draw attention to an uncomfortable historical truth: that no currency union has survived without a fiscal and political union. The contrast between the eurozone and the US would become ever starker. Many US states are also in fiscal crisis, but local problems can be solved at a federal level. Should transfers fail to do the trick, a chapter of the bankruptcy code is devoted to sub-federal governments. The eurozone lacks such burden-sharing mechanisms.

The story of the other eurozone stragglers is different in degree but not principle. All are highly leveraged – the fundamental source of financial contagion. Spain, like Ireland, has a massive contingent public liability in its banking sector, arising from mortgage debt. Its growth model – residential construction driven by a house price boom – is defunct. Spain too needs fiscal consolidation and structural reform to restore debt sustainability, reinvigorate growth and reduce its 20 per cent unemployment rate. Italy's government is highly leveraged so it too must cut spending and regain competitiveness. Portugal urgently needs structural reform to restore economic dynamism and fiscal health.

Greece, then, is the front line of a wider battle to stay on the path demanded by European Monetary Union. The political commitment to the eurozone of every country that has come under the gun is unwavering – witness Ireland's deep budget cuts; Portugal's painful deflation; the sharp adjustment of aspirants such as Latvia or Hungary. Lack of political and fiscal union, limited labour mobility but free capital movement make such adjustments critical to the long-term viability of the eurozone.

Ideally, formal rules for fiscal burden-sharing should be developed to give teeth to no-bailout clauses, such as debt restructuring mechanisms for eurozone sovereigns. Otherwise, doubts about EMU sustainability will return in every downturn. Sooner or later, these doubts will be validated.

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