Public versus private risk: Heed the lesson from Greece

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By **Star-Ledger Guest Columnist**

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Pantelis Saitas/European PressPhoto Agency

Police use teargas to battle protesters in front of the Greek Parliament building Wednesday.

Greece's current debt problems were created by government officials who used underhanded financial mechanisms to hide the size of the nation's debt and exposure to risky assets from their foreign creditors. Once these problems were revealed, the Greek economy began an endless downward spiral.

In order to protect its own banks from exposure to debts in Greece and other fiscally struggling nations, the European Central Bank created the European Stability Fund to provide bailouts. But these payments are conditional on recipient nations adopting very stiff austerity policies.

The latest round of Greek austerity measures is meeting with violent resistance on the nation's streets. The next vote could support or sink the entire bailout enterprise, with potentially huge consequences for the ECB's financial sectors and the survival of the euro.

With the twin spiral of imploding private and public sectors, it's difficult not to sympathize with Greek demonstrators. This is a problem created not by them, but by their elected officials. Yet in its outcome, it is very similar to the situation that proponents of government service and insurance provision fear and wish to protect against: a steep and economywide recession from distant and uncontrollable economic shocks and market failures. We need to acknowledge the significant possibility of government failure and understand how Greece got there.

Greece owed $587 billion to foreign creditors as of December 2010. Of that, $280 billion was owed to foreign governments and $290 billion to foreign banks.

The country's debt problem has two features: insolvency of the government and insolvency of its banks. Bailouts

from other Euro-zone countries and the International Monetary Fund can temporarily stave off government insolvency. Bank insolvency is a more difficult problem: As foreigners continually withdraw their investments from Greece, the nation's private banks are being forced to liquidate their assets, starving businesses of the credit they need to continue operating.

In a vicious cycle, worsening business prospects in an already uncompetitive economy are inducing additional capital flight from Greece. By the end of 2012, analysts expect Greek bank deposits to shrink by 40 percent compared with their amount in mid-June 2010. And ECB members are demanding additional austerity policies to bail out the state: cutting payrolls, laying off government workers, reducing public services and scaling back the overly generous (even by EU standards) retirement and health benefits of public workers and retirees.

The weight of expert opinion now is that unless it is rescued, Greece's economy will implode. But the provision of periodic bailouts may prove to be yet another government failure because they work only when the recipient institution is economically viable but short on liquidity, not when it is insolvent as the Greek state and its financial sector are.

Moreover, defaults on foreign private sector loans will adversely affect other ECB nations, chiefly Germany, where banks are exposed to Greek, Irish, Portuguese and Spanish debt; all those nations are also facing sovereign debt problems.

With a shrinking economy, it's difficult to predict when the Greek economy will stabilize, but that's key because the capacity of ECB nations to provide bailout funds is limited. That's when the ECB's financial system and the Euro will face their true test of survival.

Many proponents of broad government intervention and management of the economy, including comprehensive social insurance programs, insist those solutions to be the only way to provide needed public services and to protect workers and other vulnerable segments of the population from brutish market forces. But the recent events in Greece suggest the government's ability to operate, manage, self-insure and protect the population can be just as tenuous as that attributed by liberal-leaning analysts to the market.

Although the government can provide a qualitatively different source of risk management, it is not a fail-safe mechanism, and certainly not an unambiguous improvement over private sector mechanisms. The safer option would be to diversify between public and private sector mechanisms to protect the economically vulnerable.

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