Nobelists watched Greece hit the wall

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Steve H. Hanke, euro, Greece

By Steve Hanke

A

ll eyes are on Greece — the epicentre of the most recent financial quake. In recent weeks, Greek stock and bond prices have plunged, while prices for credit default swaps have soared. Greece's troubles have also put the euro — a currency used by Greece and 15 other members of the European Monetary Union — under pressure.

The crisis has put the recently elected (October 2009) Panhellenic Socialist Movement (Pasok) government and Prime Minister George Papandreou on a hot seat. Mr. Papandreou — who is also President of the Socialist International and whose father and grandfather served as Greek prime ministers — is experienced and usually mild-mannered. But the crisis is even testing his patience. Following the recent Brussels summit of European Union leaders, Mr. Papandreou mounted a ferocious attack on his EU colleagues, claiming that they were creating a "psychology of looming collapse."

Mr. Papandreou went on to assert that Greece had become the eurozone's first big test case with speculators: "a laboratory animal in the battle between Europe and the markets." It sounds like he is taking to heart advice from Nobelist Joseph Stiglitz, an advisor to the Greek government.

When it comes to Greece's public finances, Prof. Stiglitz has turned a blind eye. For him, speculators are to blame for Greece's troubles. The data tell a different story. Greece's government debt as a percentage of GDP tops the EU charts at 124.5% and its fiscal deficit for 2010 is projected to be 11.3%, a close second to Ireland's 12.4% deficit.

These terrible fiscal figures aren't the end of the data story, however. It turns out that Greece is a serial fiscal data fiddler. In January 2010, the European Commission issued a "Report on Greek Government Deficit and Debt Statistics." It contains a long list of infractions.

And if those weren't bad enough, it has recently come to light that Greece, with the assistance of Goldman Sachs, entered into arrangements that allowed Greece to receive cash now and pay later. This amounted to an accounting sleight of hand, with the cash inflows recorded now and the future liabilities (cash outflows) lost in a fiscal fog.

In addition to its statistical shenanigans, Greece suffers from a host of structural problems. As Michael Massourakis, the chief economist at Alpha Bank, put it in a Financial Times article, Greece is "the last 'Soviet style' economy in the developed world." The World Bank's Doing Business 2010 report supports that conclusion. Greece has the least hospitable business environment in the EU and ranks 109 out of the 183 countries surveyed.

This isn’t the first time Greece has been in financial hot water. Following its recognition as a state in 1832, Greece spent most of the remainder of the 19th century under the control of creditors. The pattern started with a default in 1832. In consequence, Greece’s finances were put under French administration. As the century came to a close, Greece’s fiscal house was entrusted to a control commission, following Greece’s defeat at the hands of Turkey in 1897. During the 20th century, the drachma was one of the world’s worst currencies. Its record was marked by the world’s sixth highest hyperinflation. In October 1944, Greece’s monthly inflation rate hit 13,800%. How will Greece’s current crisis end? At present, “Mr. Market” thinks that the EU gravy train will come to the rescue, that the crisis will be “contained” and that the collateral damage will be limited. But that scenario might be overly optimistic.

If euro deposits in Greek banks take flight and are moved to banks outside Greece, things could become much more difficult. Indeed, this bank-run/capital-flight scenario would turn the euro zone into a panic zone.

This Greek story wasn’t receiving top billing from the oracles. Instead, they were telling us that the Baltic States or Bulgaria would blow up and wreak havoc throughout Europe. In January of this year, another Nobelist, Paul Krugman, presented a “Nobel lecture.” According to him, “the Baltic nations, in particular, seem well positioned to follow in Argentina’s footsteps.”

He went on to point an accusatory finger at “Argentina’s currency board.” The problem with this assertion is that Argentina did not have a currency board. Never mind. It’s this false assertion about Argentina that allows Prof. Krugman to link the Baltics (and Bulgaria) to Argentina. The Baltic States of Estonia and Lithuania operate formal currency board-like systems (as does Bulgaria) while Latvia informally and roughly follows currency board-type rules.

The domestic currencies in these countries are fully convertible at a fixed exchange rate to the euro. Under these systems, changes in a country’s monetary base move in approximately a one-to-one correspondence with changes in foreign reserves. Accordingly, when foreign exchange flows into (out of) the country, the monetary base increases (decreases).

Even though the Baltic States and Bulgaria have taken huge hits during the current financial crisis, they have maintained their currency board-like systems and have kept their fiscal houses in order. In consequence, they have not collapsed and are on the mend. All have had their credit rating outlooks raised since the turn of the year.

While Prof. Krugman’s and Prof. Stiglitz’s authority is weighty, their arguments and evidence are slender.

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Steve Hanke is a professor of applied economics at The Johns Hopkins University in Baltimore and a senior fellow at the Cato Institute in Washington, D.C.

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