EUROPE ECONOMONITOR

Greece Like Lehman?

Roberto Tamborini | May 10, 2010 6:06PM

The Greek debt crisis with its dramatic spillovers are clearly a sequel of the catastrophic financial earthquake of 2008, and, at the same time, an early warning of the kind of situations that the world financial system will have to manage in the years to come. Whatever the specific responsibilities and contingencies may be, Greece is not, and will not remain, an exceptional and isolated case. Alas, the Greek crisis in Europe is being dealt with an astonishing mix of backward-looking conceptual mistakes and political myopia. Those who are eager to give a hard lesson to Greece are the same who hailed the Lehman's bankruptcy as a new dawn of Capitalism. If not materially the same persons (in some cases yes), the ones share with the others the same faulty, as much as obdurate, view of how modern financial systems work. A view that, apparently, has not been shaken by the crisis of 2008 and the subsequent flood of analyses and official documents explaining where the faults lie and how to fix them.

Conceptual mistakes

If there is one word that summarizes the "new view" emerged from the wreckage of 2008, this is *interconnectedness*. Its meaning is that modern financial systems by their very nature evolve into *network architectures*, with some major *hubs* to which a number of minor (local) hubs are connected together with a wide array of *terminal units*. These structures, that can also be found in other social contexts as well as in nature, are studied by means of a well-developed technique (*network analysis*), which, unfortunately, has not yet been admitted in the short list of the techniques learned by those who decide what economists should know (nonetheless a growing number of institutions like the Bank of International Settlements, the European Central Bank, or the Bank of England[1] are heading their research departments also towards network analysis, probably because they feel urged to provide operational ideas of public interest and not only for academic circles).

The architecture of interconnections is fundamental as they may determine the global efficiency and resilience of the system as well as its fragility. Moreover, the other post-crisis star, *systemic risk*, can hardly be understood and gauged without tracking network interconnections. These are critical under two dimensions. First, they are difficult to track and understand for the basic reason that good and reliable data from single financial intermediaries are required. Second, when the system is hit by a local shock (such as a liquidity or solvency crisis of an element), its ramifications (*domino effect*) may be complex and remote, more or less harmful, and should be simulated by computer based models.

Chronicles report that, in the night when Lehman was let go bankrupt, the officials and heads of the various institutions involved were unaware (perhaps owing to the lack of truthful data) of the true entity and extensions of the interconnections of the Wall Street giant that surfaced dramatically the next morning (J. Cassidy, *The New Yorker*, Jan. 29, 2010). In spite of the fact that network analysis may not be easily available, educated judgment and experience should suggest that, first, modern financial systems are strongly interconnected; second, a large financial entity probably plays the role of a major hub; third, when a major hub collapses the shock spreads itself throughout the system to extents that are not easily predictable. Yet we may typically observe an insolvency cascade across the closest partners, a liquidity crisis in a wider part of the system, and a higher systemic risk for everybody.

Dimension *per se* is not the end of the story, however. The Greek government is a *relatively small* financial entity.

Its debt, despite its huge local dimension, is worth about 3% of the Euro-zone total sovereign debt. The *initial* rescue plan of €40 bln. (of course, the more we wait, the larger it grows) was about 20 times smaller than the US Paulson Plan that in October 2008 was launched to bail out *a few private financial intermediaries*. It was also by far smaller than some *single* bail-out operations engineered in Europe such as Fortis, Deutsche Bank, Royal Bank of Scotland. The virtuous Germany has pledged resources amounting to about 24% of GDP in support of the national financial system, about half of which has already been spent (source: European Commission). Just because the mere quantitative dimension of the shock appeared modest, time has been wasted arguing whether the superior goal of EMU solidarity and stability are worth the money or the credibility of the rules of the Treaties is worth the offence of a default within the common house.

This piecemeal approach to the problem is totally misleading. The true problem is not how large the Greek debt is, or how much Greece deserves to be punished, but how Greece is interconnected. From this different angle, the situation appears quite different, and worse. I quote from the fine report prepared for RGE by Amab Das, Jennifer Kapila and Elisa Parisi-Capone:

"The problem is far from isolated, despite market price action. Greece remains heavily interconnected and, should market concerns precipitate a self-fulfilling run, contagion across a variety of areas that now appear insulated is very likely once a credit event materializes, whether in a Greek bank or the sovereign itself".

There are at least three critical interconnection and contagion paths. The first runs along the interbank relationships of Greece with the rest of the Western system. The primary banking system exposed to Greece is the Portuguese one, with more than 15% of total MFIs capital. Then there come Belgium and France (beyond 10%), Ireland, Germany and The Netherlands (between 7% and 8%) (sources: BRI e RGE). These figures indicate the order of magnitude of the additional worsening of the balance sheets of the banking systems in these countries that would be produced by a Greek default. These are banking systems that, to be optimistic, are painfully recovering from the 2008 crisis, and it is doubtful that they can survive additional financial stress.

The second contagion path spreads across the financial systems of Centre-East Europe (CEE), for which Greek represents a regional hub. Greek banks present exposition in the area ranging from 17% of total in Romania, 28% in Albania and 71% in Macedonia. They provide 22% of Albania's total credit, 23% of Romania's and 31% of Bulgaria's (source: BRI e RGE). Generally, these are not top-quality credits. It is clear that a default on the domestic state bonds that lie in the portfolios of Greek banks would force them to withdraw from CEE risky credit lines triggering a severe credit crunch in that area. It is unnecessary to remind that, also in this case, the victims would be countries that are already facing serious financial distress, are in the target of speculative markets, and are under IMF strong therapy.

The third critical interconnection line is not, so to speak, a tangible one like the previous two. It goes through the *elaboration of information* by markets. This type of interconnection is less considered in network analysis but it is of utmost importance and adds further complexity to the picture. There are at least two dimensions to be considered.

One is what I would call the *anticipatory effect*. We may well start from the classical hypothesis of informational efficiency: market participants have correct information on the interconnection between Greece and Portugal, hence they flee from Portugal precipitating the effect of the Greek default on Portugal. The other I would call the *creation effect*. It arises as the market converges on beliefs on non-tangible interconnections that are self-fulfilling. For instance, no data indicate further critical interconnections between Greece and Spain or Italy, but they are inbuilt in the market belief, in this moment, that a Greek default would justify speculative attacks against sovereign debts one after the other, and even a breakdown of the EMU. This is paradoxical since the foreseeable situation of the aggregate sovereign debt in the Euro-zone looks better than that of the UK or of the US federal debt (not to mention the alarming deterioration of public finances at state level; see here). But the self-fulfilling potential of these beliefs is in that they widen interest-rate spreads, which in turn amplify financial distress in a vicious circle.

In the total lack of consistent, visible and firm political-institutional guidance that plagues the EMU, market beliefs are catalyzed by the Stability and Growth Pact (SGP). The *idea*, that is constantly evoked in our continent, that a sovereign debt crisis (since we have seen that private crises do not matter) will *always* be treated as a single country problem, and it will *never* be treated as a systemic problem, is not written in the laws of economics, but in our Treaties. And this is sufficient for the market to *rationally* believe, *given the frame*, that if Greece will be left alone, all other countries under attack will be, up to the collapse of the EMU. This may explain the seeming paradox that the financial turmoil in the Euro-zone as a whole was initially triggered, not by the determination to support Greece, but exactly for the lack of determination.

Political myopia

Germany figures prominently in this desolate picture, apparently being regressed several decades backwards to her original post-war condition of economic giant and political dwarf.

The German leaders seem prey to of the popular-populist idea according to which the euro is only a sacrifice that the Germans have nicely accepted to the advantage of the rest of Europe in exchange for the release of the Eastern brothers. This is just propaganda. All member countries in the EMU have both costs and benefits. Benefits for Germany are indeed consistent and materialize in the protection of one of her fundamental assets: a free trade, fixed exchange-rate area of continental dimension in which about two thirds of her most beloved exports can circulate free from the threat of competitive devaluations. The phenomenon, it should be reminded, that had destabilized the European economy, and hindered the German one, after the collapse of the Bretton Woods exchange-rate system. In the last decade, the Germans have obtained substantial real competitive gains *vis-à-vis* the Euro-zone thanks to a wise combination of domestic policies. Bravo! But this means that, in this moment, sharing a common currency represents a heavy burden for her competitors, not for Germany, as is testified by the distribution of the current account imbalances in the Euro-zone. True, the Southern Pigs would suffer even worse damages without the euro, but the German threat to resurrect the old idea of a small Northern super-euro is not credible. For it’s obvious, super-appreciation would shortly swallow Germany's competitiveness gains so painfully conquered, and dry up the natural outlet markets of her export goods.

Second, if it is understandable that the German taxpayers do not want to waste their money for Greece, someone should also explain them that the sole alternative is to waste even more of their money directly for another bail-out of their banks. This is the tortuous complexity of network systems that disturbs the lovers of linear thinking, but that cannot be ignored by responsible policy makers.

The further argument that wants Germany as the stainless observant and defender of the rules should be put aside. As has been reminded no less than by Theo Waigel, the Kohl government's Finance minister who imposed the SGP as condition for the euro, the first country that breached it was Germany in 2003 (with the complicity of France and Italy). Moreover, in this moment Germany presents private and public financial conditions not to be taken as examples of virtue. It should not be forgotten that if the US has been the world epicentre of the crisis, Germany has been the continental Europe epicentre. As recalled above, the German financial system has already swallowed public resources of various nature by more than 10% of GDP. The German-shaped ECB, which should abstain from direct purchases of public bonds, has recycled trash paper from private financial institutions of dubious public interest, many of which of German origin, to an unprecedented scale.

A clear and irreversible choice for the euro should be presented as it is: a national interest of Germany, and consequent political actions should ensue. Among these, a certain degree of fiscal solidarity with partners, or some devolution of competences to the Community level, can no longer be missing. True, this is not only Germany's responsibility. However, also on this front, the leaders of the leading country seem to surf populist emotional waves rather than channelling them into rational, farsighted polices.

A new approach is needed (urgently)

How can another Greece be avoided? A new reform of the SGP (the second in few years) is being invoked. Some wish to make the existing rules more binding and mechanical. Of course, never more we would like to see public (and private) cooked books. But the sheer tightening of the present rules would be the wrong solution because these rules are intrinsically flawed. I only mention a few points among various others that are in the literature ever since the conception of the euro.

First, too much focus is on budget flows on a short-term basis, and too little on debt stock sustainability on a long-term perspective. Second, recessions induce pro-cyclical fiscal policies. Third, the dimension of control, protection and responsibility for fiscal systemic risks is non existent. The idea that a currency union can only work if each and all members' budgets remain "close to balance or in surplus" on average, and no large fiscal shocks ever occur to the union as a whole, is pure nonsense. These risks exist! As in the US or Canada, it is necessary that each member country complies with rules of fiscal responsibility at home in ordinary times, but it is also necessary that somebody thinks for the union as a whole in extraordinary times (at least).

With regard to both the network effects that I have mentioned above, public authorities bear responsibilities of the utmost importance. First, they should seek to ascertain as best as they can the interconnections in the system in any given situation. Second, they should intervene quickly and effectively in order to inhibit the interconnection anticipation and creation effects by markets. In some cases these interventions may take place on different fronts with a variety of instruments, both where the shock is located (a bank, a country …) but also where the interconnections arrive. Leaving this global level of fiscal responsibility to contingent negotiations among condominium housekeepers is devastating, as is sadly under the world's eyes these days.

The concepts of interconnection and systemic risk make the defenders of financial orthodoxy nervous because they see them as a Trojan horse for bailing out profligate spenders thus undermining market discipline. This attitude is surprising because it is financial orthodoxy itself that (correctly) recommends open markets, financial integration, creation of large global players competing for financial efficiency. The euro has been created also for these reasons. Financial network systems with some nodes "too big to fail", or "too interconnected to fail", are not an opinion or an ideology: they are the consequence of these policies. We cannot have one without the others. All this means that the no-bail-out threat, in financial systems of this type, will not be enforceable for most of the subjects and cases in which it should bite. The discipline of moral hazard should be entirely reconsidered. For instance, as suggested by Roubini, the collapse of a hub may be tolerated by the system provided that its interconnections are cut off, that is to say, if adequate measures are taken to protect all the interconnected subjects.

In Europe, in the present juncture, the piecemeal approach should be abandoned immediately. Either we definitely rescue Greece or any other solution should include a safety net for all the other interconnected parts in the system. As the market reactions are clearly indicating, the false wisdom of the Treaties that everyone should stand alone against the wind can only pave the way to the wreckage of the euro.

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[1] See e.g. A. G. Haldane, "Rethinking the Financial Network", April 2009, Bank of England, mimeo.

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