

## Greece and the euro crisis

*by Dr Stefan de Vylder \**

Once upon a time a group of friends formed a club with certain common rules for economic behaviour. No-one was - in theory – allowed to incur debt above a level established by the statutes. And no-one was allowed to leave the club. Both rich and poor friends were granted membership, but thanks to the solid economic position of the wealthier members, every member of the club was regarded as creditworthy. The rather indolent banks were, for a long time, of the opinion that no member of such a fine club could ever default on its debt.

As time went by, more and more members were welcomed into the club. After ten years the membership reached seventeen. But by then the cosy atmosphere had been replaced by rising tensions, largely as a result of growing income disparities between the individual members. One of the members had become a multimillionaire, another a well-to-do physician. The club also contained a couple of teachers and nurses. But there were also a couple of construction workers who had lost their jobs in the wake of a financial crisis as well as a careless fellow, who had never learned to manage his own economy.

Now even the banks began to have cold feet. Perhaps some of the members of the club suffered not only from illiquidity, i.e. a temporary lack of liquid funds, but also from insolvency, i.e. are unable to service their debts even in a medium-term perspective?

The wealthier members of the club were increasingly concerned. Things were not working smoothly any more. The annual midsummer parties were not what they used to be.

To postpone the day of reckoning, the club began to extend loans to the poorer members.

The richer members – who just a couple of years earlier had applauded the rising consumption and welfare among the poorer ones – started to bully their less fortunate friends. “You have been living beyond your means”, they shouted in chorus. “Lazybones!” To extend new loans - at a high rate of interest - the club’s board of directors demanded a reduction in the order of 20-30 per cent of the poorer members’ disposable incomes. “But if we do that, the real burden of our debts will be even heavier, and more difficult to service”, whined the low-income and unemployed members. “That is your problem” was the answer.

One board member however raised a pertinent question: “Is it really our responsibility to bail out our poorer members? Shouldn’t the banks, who have lent so much without asking questions about the borrowers’ creditworthiness, be forced to foot part of the bill?”

“No way”, said the board majority. “A debt restructuring would make the financial markets more nervous. The important thing is to make sure that the banks get their

money back. A better solution is to put our destitute friends under guardianship and force them to pay.”

Such clubs do not exist, the reader might argue. But unfortunately, we have such a club: The European Monetary Union, EMU. A club with the wrong membership and an incompetent management. To create a monetary union with a large number of countries with completely different economic conditions and development paths, but with a common currency and a common rate of interest, is simply not good for the maintenance of friendship between the member countries. What we have seen so far of mutual accusations, rising nationalism and even ugly xenophobia is just the beginning. The EMU is set up for conflict.

Although Sweden is not a member of the EMU, our minister of finance, Anders Borg, is one of the worst bullies. The Greeks earn too much and work too little, is his oft-repeated message. But at the last midsummer summit, he offered the Greeks a word of consolation: “Sweden found itself in a severe crisis in the early 1990s...But recovery was far more rapid than was envisaged” (Dagens Nyheter 24 June 2011).

But there is one decisive difference. In 1992 Sweden could, after several years of higher inflation than among our major trading partners, abandon the fixed rate of exchange and let our currency float, i.e. sink. If we had managed to defend a fixed and overvalued rate of exchange, our crisis would have developed into a complete disaster.

Today a number of euro-zone countries are confronted with a similar problem, but without the exit option that Sweden had in 1992. The 17 members exhibit huge and growing differences in productivity and costs. Around ten of them have seen their international competitiveness eroded, not least as a consequence of Germany’s low inflation, rising productivity and spectacular trade performance, which has made the euro strongly overvalued for the weaker euro countries (but undervalued for Germany, which registers a huge surplus on its current account).

In order to improve and even restore their international competitiveness, the countries in crisis are today forced to carry out what economists call an internal devaluation, i.e. a drastic cut in nominal costs and wages. As long as they are locked into the same currency union as Germany, they have to enter a race to the bottom: an inexorable reduction of income and welfare.

The combination of new loans and deflationary policies which is prescribed today has the inevitable effect of aggravating their insolvency. As incomes shrink, the debt burden becomes increasingly heavy.

An internal devaluation has another snag: the effects on the real rate of interest. In a currency union the nominal rate of interest is the same for all member states. The real rate of interest, that is the difference between the nominal rate of interest and the rate of inflation, is however dependent upon each country’s inflation. If the countries in crisis do manage to implement deflationary policies which reduce wages and prices, the real rate of interest on their debt would become exorbitantly high, with devastating consequences for investment, employment and tax revenue.

A collapse of the EMU – perhaps as a consequence of Germany’s refusal to bail out an increasing number of members of the euro zone – would inflict huge costs. When the financial markets become convinced that the EMU will break down, we are likely to see a prolonged period of financial turbulence and an accelerated capital flight from the weaker member countries. A threatening scenario, indeed. But the longer it takes for Greece and some other countries in crisis to be granted an orderly debt restructuring and an exit from the EMU, the higher the bill to be paid.

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