Forbes.com

Capital

# This Greek Tragedy Is Only Beginning

Thomas F. Cooley, 06.02.10, 6:00 AM ET

We have only seen the first act of this modern day tragedy--the sad tale of promises made that cannot be kept. After years of profligate spending and expansion of the public sector, the credit markets finally pulled the plug on Greece, making it all but impossible for the country to roll over its enormous debt. The specter of sovereign debt default by an E.U. member state so rattled markets that there were serious signs of contagion spreading to Portugal, Spain and Italy in about that order. The E.U. finally agreed to a community-wide lending facility, and the European Central Bank began buying sovereign debt. This seemed to calm markets briefly--but it shouldn't have. The drama is just beginning.

For the next several years Greece will face a huge drop in output and consumption. The magnitude of the drop in Greece will dwarf the U.S.'s experience in its recent recession. It will take years for consumption levels to return to anything close to pre-crisis levels. Wages will fall, and access to capital markets will be limited. Greece will be forced to restructure its debt. Several of the other debt-burdened economies in Southern Europe will face similar, painful adjustments.

The Greek story is familiar by now, but some of it is worth repeating. Greece's economy has been hugely uncompetitive and burdened by a bloated public sector that accounts for 40% of GDP. The projected fiscal deficit at the end of 2009 was 12.7% of GDP, and its outstanding debt is 124.9% of GDP. About 80% of the debt is external, meaning it is held by non-residents. Interest payments on the debt account for nearly 40% of the projected fiscal deficit--nearly all money that will flow out of the country. Greece is notable for its tax evasion, lack of transparency and large inefficient bureaucracy. Its pension system encourages early retirement with generous benefits.

According to Aristotle, the structure of Greek tragedies is such that the central character, however well-meaning, is brought down by a character flaw, usually hubris. The excessive pride begets decisions that lead to misery, and the realization of the failure always comes too late to reverse it.

It didn't have to be this way. The E.U. stretched its rules to allow Greece to join the currency union in 2001, a year before euro notes and coins went into circulation. Greece had every incentive to make it work. The stable currency meant low inflation and low interest rates for most of the euro's first decade. There was a very strong incentive to compete in the eurozone and instill fiscal discipline. Instead Greek politicians used it as a reason to borrow, creating a mess they won't easily escape. It is ridiculous to blame this problem on the euro.

On one level the Greeks' problem is relatively simple. They have made promises they can't possibly keep. They can't afford to have the level of tax evasion they now have; they can't afford the bloated public sector; they can't afford their pension system. That will have to change. The logic of improving the efficiency of their labor markets is inescapable. Whether they have the political will to do what is needed is another matter entirely. They have been beset by a series of nationwide strikes led by government employee unions since the austerity measures were announced.

The larger problem is their debt. The E.U.'s borrowing facility, combined with the International Monetary Fund's intervention, is a temporary solution that does more to help the holders of Greek debt than the Greeks themselves. It is at best a temporary stop-gap that only kicks the can down the road. Like other promises Greek politicians made that they can't keep, they may not be able to pay their debts. They can't grow their way out of the problem, because their economy is too inefficient. All the evidence suggests they will have to either default or restructure.

Countries that back themselves into these problems suffer greatly to get out of them. A good example is Latvia. It has undergone a similar painful adjustment following a fiscal crisis that saw its debt rated as junk. In the fourth quarter of 2009 Latvia's GDP fell by 18%, and it has fallen a further 10% in the first quarter of 2010. Wages fell an average of 8.8% in the most recent account, and unemployment reached more than 22%. This is a Great Depression-caliber contraction.

Argentina is another example. In 2001 and 2002 Argentina experienced an economic crisis that led the South American country to alter its currency peg to the dollar and restructure its debt. The underlying problems had a lot in common with Greece. The short-term results were catastrophic. GDP fell by more than 18% at its worst point in 2002. Consumption fell by 18% and stayed well below its previous trend for many years. The unemployment rate soared to nearly 25%. Argentina has recovered somewhat, but the social costs were enormous.

---

It remains to be seen whether the Greek population will put up with pain of that magnitude. It will not be alone. Ireland has already faced up to its problems to some extent and is suffering from a sharp contraction. Portugal is next in line; its net external indebtedness is very high, and it suffers from inefficient labor markets.

Then comes Spain, a much bigger problem for Europe. Like Greece, Spain has a very large external debt. Its budget deficit is 11.5%, and it has an unemployment rate above 19% because it has avoided reform of its labor market policies that make it incredibly costly to remove permanent employees. Spain has only just passed an austerity budget.

So what portents does this Greek tragedy have for what lies ahead? It is clear that eurozone economies are going to face a period of austerity and retrenchment. Britain has to deal with its fiscal problems, as do Italy and other major economies. We are looking at some major contractions in output, consumption and employment just at a time when the economic recovery seems to be getting legs. Not all of those affected are small economies like Greece, Portugal and Ireland.

Maybe the best lesson is one that we in the U.S. seem to be in denial over. How did all these countries go wrong? Simple: Interest rates were low, so they kept borrowing to finance pressing short-term needs. Sound familiar?

*Thomas F. Cooley is the Paganelli-Bull professor of economics and emeritus dean of the NYU Stern School of Business. He writes a weekly column for Forbes. He is a co-editor of the forthcoming book* Regulating Wall Street: The New Architecture of Global Finance *(Wiley, 2010).*