FLEMING ON FINANCE

The mood turns apocalyptic

Saving Greece is about more than bringing that country back on track, writes Stewart Fleming. It is about ensuring that the EU continues to be a global economic power

Is the European Union finally waking up to the scale of the political and economic challenges it faces? Last week, at a seminar in Brussels led by Notre Europe, a think-tank, the apocalyptic mood, even among government officials who normally let their political masters do the talking in public, was unmistakeable.

With the financial crisis in Greece exploding all over the European media, Michael Claus, a director-general for European affairs at Germany's foreign ministry, spoke bluntly. For the European Union in the next 18 months, "the top priority will be to save the euro", he said.

By last weekend the chances of achieving that objective were brightening just a little. The stand-off between Germany on the one hand and the European Central Bank and France on the other, over how private-sector lenders to Greece should be cajoled into participating in the Greek bail-out was apparently resolved.

The compromise reached by Angela Merkel, Germany's chancellor, and Nicolas Sarkozy, France's president, means that the International Monetary Fund (IMF) will withhold the *coup de grâce* from Greece. Provided Greece's parliament approves a new economic austerity package, the IMF will distribute around €12 billion to Athens so that the EU/IMF bail-out can continue to wobble on. Febrile financial markets should calm down again – for a while, at least.

But all that has happened is that the participants may have bought some time. Later this year the Greek financial crisis will be back on the front pages. Economists at Barclays Capital, an investment bank, have correctly concluded that, given the likely interest rates that Greece faces on its debts of around 150% of gross domestic product and its feeble medium-term growth prospects, Greece's "public-debt dynamics [are] unsustainable and a restructuring [of its debts] is inevitable".

If the IMF, most probably under Christine Lagarde as the new managing director, had to come to this conclusion too, then the IMF disbursements would have to stop.

Muddling through

Nouriel Roubini, a US economist renowned for his gloomy prognostications, wrote on 13 June that "the muddle-through approach to the eurozone crisis has failed to resolve the fundamental problems". If this continues, the result will be "a break-up of the monetary union itself", he warned.

This, however, is to give 'muddling through' a bad name. In 1982, Mexico defaulted on its international debts, triggering the worst international debt crisis in modern times. Over the next eight years, more than a dozen Latin American countries eventually had to be 'bailed out', with help from the IMF, the US Treasury and (mainly) US banks. Had Washington not led the rescue, then the US banking system, which was over-extended in Latin America, would itself would have collapsed, according to Harold James, the official historian of the IMF. The crisis would then have gone global.

The managing director of the IMF at the time was Jacques de Larosière, a former governor of France's central bank. Jean-Claude Trichet, now president of the European Central Bank (ECB), was a senior French treasury official. Then, as now, he was actively involved in the ultimately successful 'muddling through' strategy that helped Latin America through its 'lost decade' of growth.

EU officials are well aware that the crisis now facing Europe is much more challenging. Latin America's crisis was overwhelmingly about US bank lending. It did not involve publicly traded sovereign bonds monitored by credit-rating agencies – whose venal incompetence was exposed by the 2007 sub-prime debt crisis, but who nevertheless still wield so much unaccountable power.

The Latin American countries in trouble were not part of a currency union. Greece's troubles can affect – and have already affected – the likes of Portugal, Ireland and Spain, and continue to threaten the euro itself. This gives their governments leverage in negotiations that Latin American debtors did not have, once US bankers had been bludgeoned into rolling over their loans.

Perhaps the biggest difference was that de Larosière and Paul Volcker, the then chairman of the US Federal Reserve Board, welded themselves into a formidable team. Volcker could be bold. Unlike Trichet today, he was leader of a long-established central bank, in a unitary state, blessed with incontestable political legitimacy. With de Larosiere he provided visionary leadership. We have not seen much of that in Europe since the Greek crisis broke.

Early last year, when the extent of the Greek crisis started to become apparent, Germany's top priority was to avoid a financial Afghanistan – a protracted engagement with a troubled debtor. It wanted to provide support only when all other options were exhausted, even though history and long IMF experience, teaches that it is better to tackle such crises early than wait until everybody is staring over the edge of the cliff.

Manna for speculators

More recently, Germany has lumbered into a bitter, confidence-destroying, all-too-public confrontation with the ECB and France – manna from heaven for greedy financial market speculators.

If Roubini is to be proved wrong, then this bungling has to stop. Yes, fierce pressure has to be exerted on Greece's political leaders – and their voters – to reform not just their economy, but their corrupt and anarchic country. It beggars belief that Greeks still do not seem to understand that, without reform, they are facing economic oblivion, not just a lost decade.

Another reason for maintaining the pressure on Greece is to demonstrate to Spain, Portugal and Ireland, that bail-outs are not hand-outs. Private-sector bankers with loans out to Greece, who baulk at acting like responsible lenders, need to know that regulators and supervisors can play dirty too, albeit behind the scenes.

But Claus, speaking at last week's Notre Europe seminar, was wrong in at least one respect. It is not just the survival of the euro that is at stake. If Europe fails to raise its miserable potential economic growth rate and implement the reforms needed to compete effectively with China, India, Brazil, Indonesia and other emerging economies, then it will be embarking on the journey to irrelevance that has been the fate of many great cultures in the past.

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