

## Why Greece Matters

Greece's economy, which has a total annual GDP of around \$330 billion, is the 30<sup>th</sup> largest economy in the world and in some senses its relatively small size would seem to suggest that financial markets' recent preoccupation with the country's travails is somewhat overdone. However, the Greek crisis has revealed three things, namely the glaring fault lines and structural shortcomings that lie at the heart of the Euro project; the fact that many OECD governments simply cannot afford the 'medical bills' associated with keeping their economies in fiscal policy-induced intensive care; and the fragility that continues to lie at the heart of the global financial system. None of these factors bode well for the global growth outlook or for corporate profits.

Beginning with the problems of the Euro area, we can see that the Greek and for that matter, the looming Iberian crises, all of which were entirely predictable, are, at their core, the product of the mis-match between the Euro area's monetary borders and the currency's political borders. From the mid 1990s until earlier this year, the Southern European states, despite their checkered monetary histories, were given interest rates through their membership of the Euro System that were more suited to monetarily

conservative Germany and the result has been that each of these economies has suffered competitiveness-sapping credit and housing booms that have distorted their economies to an almost



*Andrew Hunt  
International Economist*

unprecedented level. Now, these economies must restructure back towards their production rather than construction sectors and at the same time restore their competitiveness through either the adoption of weak currencies or a severe domestic deflation that will bring down property prices and wage rates as well as both government and corporate revenues. Although many analysts preach (almost with puritanical zeal) the deflation route and endeavour to prescribe the means necessary to achieve this deflation, we believe that such a strategy will guarantee widespread public and private sector debt defaults and bring about distressing levels of political instability.

For example, in order for Spain to regain its competitiveness through wage reductions, the level of unemployment benefits must first be reduced (so as to raise the opportunity cost of unemployment and so encourage wage

flexibility) but it will be a brave government that cuts unemployment benefits when 50% of its under 25s are unemployed. To us, the deflation route is neither optimal nor practical, particularly in a political sense and the Asian crisis of the 1990s in many ways proved this logic. Despite their flexible labour markets, not one of the Asian countries involved in the 1997 crisis attempted the deflation solution to its broadly similar crisis a decade ago.

## Survival of the Euro

We therefore believe that if the Euro is to survive, then it must become a soft currency, as indeed it has done on previous occasions when internal stress levels have increased. We therefore expect the Euro to fall over the medium term towards parity against the US dollar and to in effect suffer a competitive devaluation.



In practice, the Euro must fall so that Europe's traded goods producers (many of whom are in the already competitive core economies of Germany, Holland and Austria) can capture profits from their US, Asian, Australasian and Latin American competitors and then recycle the funds so generated into fiscal and other capital transfers into the weaker Euro countries, where the monies can be then in turn be used to service the regional debt burdens. Clearly, this removal of profits

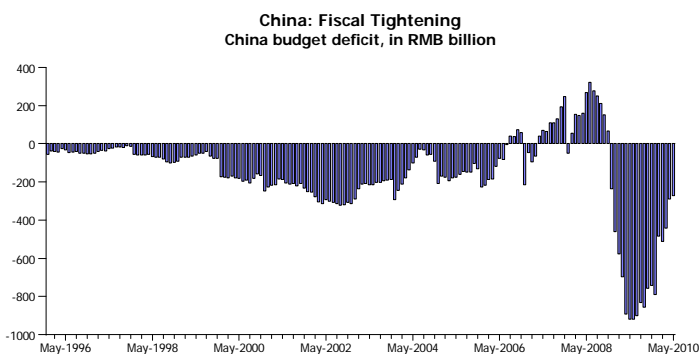
from the rest of the world and the subsequent implied use of the funds for internal debt servicing in the Euro area will be highly deflationary for global profits and even activity levels, something which financial markets are now becoming acutely aware of, judging by their recent moves. Greece may only be the 30th largest economy in the world but the effects of its crisis will be felt far and wide through its impact on Euro-wide currency policies.

The second impact of the Greek tragedy has been the warning that it has provided to spendthrift governments the world over. Although we might argue that Greece's fiscal position is in some ways a special case, the fiscal crisis in the country has led many politicians to fear their own countries becoming "the next Greece" and so we are witnessing a new trend towards fiscal retrenchment in the West.

## Incomes are Falling Again

During 2009, the household sectors of the US, UK, Japan, Australia and most places in between received very significant boosts to their disposable incomes, despite the weak labour markets. The cause of this rise in their effective spending power was in each case the expansionary monetary and fiscal policy regimes exercised by the authorities. However, as 2010 continues, we are finding that monetary policies have effectively become exhausted (i.e. interest rates are either now constrained by the fact that they are already very low or even close to zero, while in some countries they have even been rising) and that fiscal regimes are running into either real or imagined funding

constraints. Consequently, last year's household income gains are beginning to reverse. Indeed, although some countries have produced better employment figures of late, the effect of tax hikes or the ending of special tax rebate schemes are resulting in a situation in which disposable incomes are falling once again in much of the developed world, to the obvious detriment of global growth trends.



This policy reversal and its impact on economic growth is not only an OECD specific event. China has also recently embarked on not only a severe fiscal tightening but also a monetary tightening and a regulatory tightening and this seems set to impact Chinese growth in the near term. Indeed, we are beginning to see evidence that China is entering what may be quite a severe destocking phase that will likely lead not only to a sharp slowdown in production growth in the economy but also a reduction in its export prices as discounts are offered to customers. While the latter may help to reverse the upward trend in global inflation that was forming in the early part of the year, this Chinese inventory run down may also prove detrimental to growth trends and it may even trigger a protectionist backlash in the West as China attempts to clear its inventories by exporting them at less-than-cost prices. Indeed, we believe that China's recent

announcement of a slightly more flexible exchange rate policy was an attempt to forestall any such protectionist pressure and to avoid it becoming the next 'BP' in the eyes of the US population.

## The Flaws of EMH

For the global economy, events in Europe and the policy arena argue for a materially weaker growth outlook ahead and in particular for a significant amount of pressure on global profit margins. This is of course a situation that does not favour equity markets, although it should be noted that there may be some bright spots such as Germany which should gain from the weaker Euro even in the difficult trading environment. Unfortunately, the commodity markets, or the capital inflow dependent BRIC economies cannot be expected to be amongst the beneficiaries of this new world order.

Financial markets, and particularly 'risk markets', may also suffer a third impact as a consequence of the Greek crisis. As a result of the rise of the Chicago School of Economics in the 1980s and their Efficient Market Hypothesis ('EMH') disciples in the 1990s, many financial market participants in the investment banking and hedge fund arenas (which account for the majority of market turnover these days) rely on heavily mathematical models to regulate, control and measure their businesses. Unfortunately, there is a glaring flaw in the operation of these models, namely their complete inability to encompass increases in correlated volatility across seemingly different asset classes. Quite simply, when different apparently unrelated asset classes begin to move in

similar directions (usually downwards), then the mathematical models so beloved by students of the EMH and its associated VAR (value at risk) analysis used by the vast majority of leveraged investors and their regulators begin to malfunction. At this point, the investment banks reason that they are in effect 'flying blind' and they immediately begin to become more risk averse and to shrink their balance sheets, thereby reducing liquidity in the markets and worsening the financial system's plight. Indeed, as the mathematical models break down, many traders begin to fear counterparty risks (since under these circumstances who knows what anything is worth?) and there then begins a flight to perceived quality assets that tends to favour core sovereign bonds over riskier asset classes. Unfortunately, just such an event has occurred over recent weeks since the Greek crisis first led to an increase in volatility and we are therefore seeing signs of a new global credit crunch, which thus far the central banks seem to have been powerless to resolve (in fact, some of their technical actions have made it worse).

### Avoiding the double dip?

At present, we fear that global economic growth is losing momentum, and that profit margins will be squeezed as a result. The effect of this 'real world event' on financial markets is in turn being exaggerated by the malfunctioning of most commonly used risk models with the result that risk markets are coming under pressure, particularly relative to perceived safe assets such as Treasuries and German bonds. Unfortunately, as risk asset prices slump, household sectors around the world are being reminded of their still fragile

balance sheets and we now face the risk of a self-perpetuating rise in global savings rates which, given the weak income trends still present in much of the world, will merely intensify the slowdown, thereby creating the potential for a Japan-style vicious cycle of rising savings, weaker growth and weaker asset prices.

If the world is to avoid a double dip, then central banks must find a way to ease the new credit crunch and the world's fiscal authorities must find a way to credibly delay their policy tightening a while longer – although time is plainly running out for both parties.

**Andrew Hunt**  
*International Economist*  
**London**

### Andrew's 2010 New Zealand presentation dates:

<b>Winter Series</b>		
<b>6 August</b>	7.15am	Auckland, breakfast The Auckland Club
	12.30pm	Wellington, lunch at The Intercontinental (limited)
<b>24 August</b>	12.30pm	Queenstown, lunch Cophthorne Hotel
<b>26 August</b>	11.25am	Convention Centre Christchurch
Workplace Savings Forum		

For further details of presentations, please contact [enquiries@tyndall.co.nz](mailto:enquiries@tyndall.co.nz)  
 09-377 7220