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HOW FINANCIAL ELITES ARE SETTING GREECE AS AN EXAMPLE FOR THE REST OF EUROPE.

A financial market trap. Imagine what would happen if high ranking officials of the European Central Bank openly warned euro area banks that the hundreds of billions of 'asset backed securities' and unsecured loans which the ECB has been accumulating since the collapse of Lehmann Brothers would no longer be accepted as collateral in the near future. The consequences for financial markets of making such a suggestion at this moment in time would be devastating. Realising that the central bank is about to withdraw its extraordinary liquidity support for 'toxic assets', investors would immediately dump those 'toxic assets'. The market value of these assets would start collapsing again, thereby inflicting additional losses to the capital basis of the banking sector. At the same time, rating agencies would downgrade the creditworthiness of banks, thereby reducing the possibilities for banks to access to new equity. In short, we would have an additional credit squeeze on our hands and this would trigger a renewed recession. Obviously, this is a nightmare scenario which all policy makers, including central bankers, want to avoid.

Yet this is exactly what happened in Greece over the last weeks of 2009. For Greece, the nightmare scenario started on the 24th of November when the central bank governor urged Greek banks to show restraint when borrowing one-year funds from the upcoming ECB auction in December.[1]. Here, the background is that Greek banks have been heavily involved in a 'carry trade' in which the funds borrowed from the ECB at an interest of 1% are re- invested in government bonds yielding much higher interest rates. This allows Greece to fund its huge deficit (12% of GDP) and roll over its 275 billion public debt, while it is at the same time a profitable business for the banking system.

The central bank governor's warning had the rather straightforward result of raising concerns in financial markets about the creditworthiness of Greece: If Greece's government finances are, through the banking system, so dependent on central bank liquidity and if the central bank is openly questioning this liquidity support, the logical outcome is that investors will start to distrust Greek government bonds.

The next step in this nightmare scenario was taken by the chairman of the eurogroup. Two days later, on the 26th of November, Jean Claude Junckers addressed a letter to the government of Greece, calling for urgent measures to cut the deficit, restore competitiveness and implement structural reforms. This letter was then leaked to press. At the same time, other finance ministers (French minister Christine Lagarde

[1] Banks in Greece are now borrowing 38 billion euro from the ECB's liquidity schemes which, in terms of their bank assets represents 8%. (Irish banks, by the way, go further, borrowing 98 billion from the ECB or 5.9% of Irish bank assets)

for example) were also openly calling for Greece to undertake tough fiscal consolidation[2].

With all this these central bankers and finance ministers publicly warning Greece, the financial marketplace's attention was indeed awakened. On 8th December, Fitch downgraded the rating of Greek public debt to a BBB –, while mentioning the likelihood of further downgrades in future. This actually means that, from the moment the ECB starts implementing its 'exit' strategy (sometime in 2010?), Greek bonds will no longer have access to the central bank liquidity window since at least a one A rating will then be required.

The end result is a typical 'self fulfilling prophecy' of financial markets. Risk premiums embodied in interest rates and prices to insure Greek government debts are now sky rocketing. Bringing down the deficit, let alone the debt ratio, will be painful if the interest rate to be paid on government debt is higher than 5%. The default that financial markets fear actually becomes less unlikely exactly because Greece is now charged with interest rates that are excessively high.

Are the Greek 'fundamentals' so bad?

Why is Greece being singled out when there are other countries that show somewhat comparable trends? The UK deficit, for example, is also at a record high of 12.6% for 2009 with the UK government planning to push fiscal consolidation efforts back in time: The 12,4% UK deficit will basically remain unchanged in 2010 and even in 2014 the deficit would still reach close to 5% of GDP. And while it is true that Greece is starting out from a higher level of public debt, the fact that the Greek economy has been much more resilient to the crisis (GDP only shrunk by 2% compared to 4% in the rest of Europe) as well as the fact that Greece, again in contrast to much of the rest of (Western) Europe, usually manages to record high economic growth (as high as 5% in economic upturns) and high productivity growth (3% in the phase of the economic upturn) should also be taken into account.

Why this playing with fire? The chain of events described above illustrates that public declarations from Europe's financial policy elite have played a certain role in getting Greece into a financial market trap. Why have central bankers and finance ministers actually been assisting in the erosion of financial markets' confidence in the public finances of Greece?

While the formal answer is that financial Europe does not want to see one of its euro area members heading for a default, the fact remains that forcing Greece to pay excessive interest rates does not really help. There must be other and more convincing motivations for the European financial elite and these might be the following ones.

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[2] This also means that the procedures as written down in the European Treaty, to provide warnings on economic policy to individual member states were simply ignored. In doing so, the principle that the right to initiate draft legislation and recommendations is the Commission's prerogative has been breached.

A first reason may have to do with the European level discussion on 'fiscal exit strategies'. Now that the banks have been saved (at least for the time being), European finance ministers and central bankers are actively promoting 'early' fiscal exit strategies. In their view, fiscal deficits should be cut from the moment economic activity stops falling. However, this view is not completely shared by the heads of governments in the European Council. Heads of governments seem to be recognising that the jobs crisis will continue even if the economy is out of technical recession. Therefore, they have indicated a certain preference to postpone the start of the fiscal exit strategy until the moment employment recovers as well (see the conclusions of the October informal council). With Greece now being hit by perverse financial market turmoil, finance ministers and the ECB have now underlined the consequences of running high deficits, thereby significantly strengthening their case for early fiscal exit strategies.

What may also be bothering the European financial elite is the fact that Greek banks have basically used all of the liquidity support of the ECB to fund the public sector instead of saving the banking sector: The 38 billion withdrawn as liquidity from the ECB by Greece's banks corresponds to a banking portfolio of 35 billions of public debt. Moreover, the rising public indebtedness of Greece does not reflect support for the banking system to the same degree as in the rest of Europe. Whereas European member states have on average supported the banking sector by 50% of GDP (this amounts to three trillion euro for the whole of Europe!), the support for banks in Greece is limited to 10% of GDP. Both trends do not fit well with the mindset of the ECB : The central bank's emergency liquidity should primarily be used to save the banks and their 'toxic' but private sector originated assets and should not (totally) end up in social and public expenditure instead.

Finally, the intention of the incoming socialist government to tackle the deficit by fighting tax evasion did not go down well with the European financial elite either. Not so much because this kind of measure would not be credible (Greece holds the European record of around half of total employed being in the form of self dependent workers, there are most certainly important tax gains to be made here!). The more relevant reason is that such a fight against tax evasion is on the revenue side whereas finance ministers' and central bankers' mainly want public and social expenditure to be cut.

What the case of Greece is telling us. What is happening to Greece is telling us that the power of financial markets is still going largely unchecked. Despite the fact the financial crisis has saddled our economies up with massive losses in economic activity and employment and has simply ravaged public sector balance sheets, policy makers are still dancing to the tune of the financial marketplace 'logic'. It is simply astonishing to observe that the same Wall Street rating agencies that gave triple a ratings to what are now called 'toxic' assets are now being allowed to stir up trouble, in particular for those governments which deviate from the orthodoxy of the financial marketplace.

The Greek case is also illustrating that those whose job it is to control and correct global financial markets are still adhering to the old policy paradigm of 'more market

and less state'. There is a 'double standards' approach at work amongst finance ministers and central bankers: Private sector (banking) decisions are considered to be 'rational', therefore they deserve the back up from the state. Public sector initiative on the other hand is highly distrusted. Banks need to be bailed out from irrational financial market turmoil but not fellow European member governments.

Moreover, Greece is not the only case in which this neo liberal approach of the European financial elite is being applied. A similar approach is also visible for Spain. Here, the governor of the Spanish central bank is openly advocating a deregulation of the Spanish labour market (easy firing, weaker collective bargaining, wage cuts) in order to push the Spanish economy into deflation (Financial Times, 19 November 2009)! Here, the neo liberal policy bias is revealing itself very clearly. It's not price stability –a virtue central bankers have been preaching for decades - but 'competitiveness' together with big profits and dividends which appear to be the real priority for the Spanish central bank governor. As the Spanish (socialist) government is not inclined to obey the central banks' flexibility wish list, financial markets are called to help out here as well: On December ???, and although the public debt of Spain is actually lower than Germany's, Spain's rating was downgraded by …...?????? The report which was at the basis of this was signed by a high level official from….the Spanish central bank. The similarities with Greece are striking: If governments do not listen to central bankers, the latter will work to mobilize the power of the financial marketplace in order to punish politicians with high interest rate costs. In this way, democracies are dominated by central bankers holding neo liberal agendas.

How to force the European financial elite to change their bias in favour of markets and banks? One step forward would be to make sure the voice of labour is clearly and loudly heard in the circles of central bankers and finance ministers. Here, the example of countries like Belgium and Austria is illuminating. In both countries, trade unions together with employer organisations meet with the central bank board on a systematic basis. In this way, central bankers are no longer in an 'ivory tower' and their 'natural inclination' to listen to fellow bankers and to 'trust' the (financial) marketplace is offset by social partners stressing the fact that the real economy (jobs and growth) also matter. A similar structure, with European social partners engaging in an intensive and structural dialogue with both the Ecfin Council as well as with the board of the ECB itself, should be urgently considered. Such a structure would at least have the advantage of discussing real solutions to address the irrationality of global financial markets (issuing of a common Euro Bond, central bank money for public investments, coordination of tax policies to discourage excessive savings in Europe,….).

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