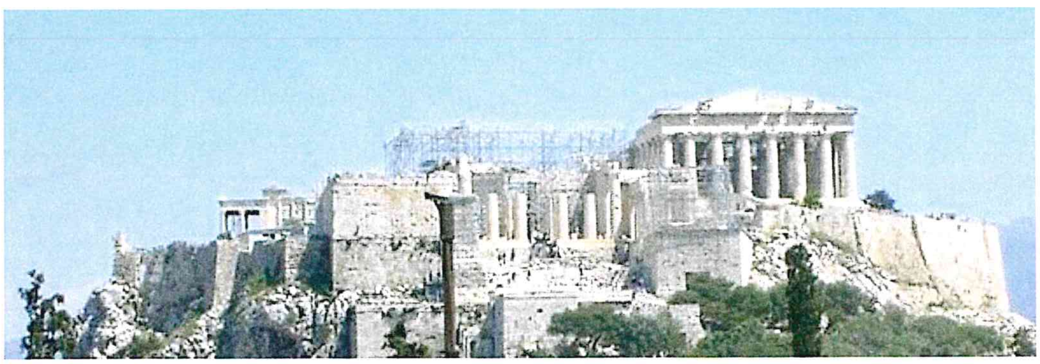
Europe's Imperative: Save Greece, Save Itself

By Hilda Ochoa- Brillembourg

At this moment, it's more important to build confidence than character in Greece and other struggling countries in the EU. Why is that so hard for Europe's leaders to understand?



Effective crisis resolution tragically requires a dynamic and subtle management of seemingly disparate objectives: building character versus building confidence. And "tragically" is the right adverb, because the European actors--Germany on one side, and most of Europe on the other--are clashing to destructive effect in negotiating these tradeoffs.

Germany is intent on building "character" among the so-called PIIGS: Portugal, Italy, Ireland, Greece, and Spain. To the Germans, building character is more important than building confidence. Ironically, when it comes to their own banks, the Germans have few qualms about building confidence in their banking institutions by helping restore liquidity and capital. As well they should, but that is not enough.

Of course, the European Union was not put in place to promote moral hazard among its members. It was established to support trade, productive efficiencies and monetary discipline among European trade partners and the rest of the world. And it was a real success. But the job was left incomplete. Achieving fiscal coordination and discipline was not feasible when the agreements were being negotiated in the 1980s. That task is before us now, and this crisis gives the European leadership an opportunity to do exactly that. But first the most immediate liquidity and solvency problems have to be resolved in a way that builds confidence and an ensuing commitment to fiscal reform, as well as creating an effective lender of last resort to address fiscal unbalance.

> The cost of rescuing Greece is a fraction of the cost of the EU's collapse.

Effective leadership in Europe requires building both character and confidence. The costs of allowing the PIIGS to default and leave the EU would be destructively high for all. UBS estimates that a "weak" country leaving the euro would suffer a 40%-50% loss in GDP in the first year alone, which would be followed by significant losses for many years to come. The cost to a "strong" country like Germany of leaving the Euro would be a 20%-25% loss of GDP the first year followed by an additional 10%-12.5% of yearly GDP losses for many years following. The losses would stem from unpaid debts leading to banking, corporate and other credit contraction failures. By contrast, the same analysis concludes that a rescue of Greece, Ireland and Portugal entirely by Germany would amount to about 3% of German GDP for one year alone. Of course, no-one is asking Germany to bear this whole load. Even the BRICs have indicated their interest in helping fund an organized debt restructuring.

In fact, given the BRICs interest in solving the crisis, another alternative and potentially effective tradeoff between regional, political and economic realities, would be to accept the BRICs offer to help fund the European liquidity shortfalls. Simply, a special fund could be created at the IMF for the purpose of recapitalizing banks and facilitating debt restructuring, along with bringing fiscal policy coherence in the European Union. The BRICs would then get their fair share of voting power at the IMF, which they so clearly want, need and deserve. This would be a good bargain to strike at the right time: Now!

Building confidence, it should be clear to all, is less expensive than building character at this juncture. But building both is paramount and possible, if politicians focus on leadership rather than placating impulsive voters. We can build character along the way by acknowledging there is much blame to go around and correcting the weaknesses imbedded in the European Monetary Union. There is no foolish debtor without a foolish creditor, much like there is no graft without those willing to support corrupt politicians. There should be failures at times like this--but individual depositors need to be protected, and bankers cannot be shielded from their own mistakes at the expense of governments.

So yes, European leaders have to build both confidence and character, and they must assume political and financial responsibility for their own lending recklessness. These responsibilities include strengthening the European Central Bank's balance sheet, or indeed its multilateral equivalent; serving as a lender of last resort; and agreeing to coordinated fiscal policy practices over time, as the IMF has encouraged developing countries to do in exchange for facilitating sources of capital. It will take years to do so. But enough already about moral outrage: The stakes are too high. Intelligent process management must trump even the most outraged moralists in this debate.

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