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The Crisis in Greece: Rhodes is here, here is Where You Jump!

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A major test for the resolve of the EU

The current situation in Greece closely parallels an episode in Aesop's Fables. In the story, a man boasted that he could jump farther than an Olympic athlete when he was on the island of Rhodes. A bystander replied that, if this is true, "Rhodes is here, here is where you jump!" (Hic Rhodus hic saltus.) The moral of this story is that one's capabilities are meaningless unless they can be put to use on the spot. This is the test that the EU now faces.

The Greek financial crisis is caused by rising fears that the country will be unable to meet its bond obligations. One reason is massive budget deficits. The annual budget deficit is currently 13% of GDP, more than four times higher than the EU cap of 3%. Furthermore, gross central government debt is 120% of the Greek GDP. Another reason is an enormous current account deficit that is equivalent to about 10% of GDP. Mounting fears have caused the risk premium (the gap between interest rates on Greek government bonds and the government bonds of Germany, which has Europe's highest credit standing) to skyrocket. S&P's decision to its credit rating for Greek government bonds to BBB+ late in 2009 immediately triggered market instability. Greece, which relies on foreign investors to buy the majority of its debt, is now on the verge of defaulting on its bonds and watching its government become effectively bankrupt.

Why everyone is so nervous about financial difficulties in a country that accounts for only about 2% of the EU's GDP? Investors are fearful about the spread of debt problems to other countries if the crisis in Greece cannot be brought under control. For example, Portugal's budget deficit is 7% of its GDP and the current-account deficit is 10% of GDP. These percentages are 10% and 5% in Spain and 12% and 2% in Ireland, respectively.

The three possibilities for Greece: A recession caused by an austere budget; removal from the EU; assistance from other countries

I believe there are three possible courses of action. The first is to have Greece resolve this crisis on its own by adopting an austere budget. The second is to cut Greece loose from the euro as countries using this currency increase their expenditures year after year and devalue its currency. The third possibility is an emergency financial aid package backed by the European Central Bank, IMF and individual countries (Germany, France and others). Option one would make the problem worse by causing a deeper economic downturn. Option two is inconceivable because it would probably be the precursor to the destruction of a single European currency. That means Greece must be rescued in order to save the euro.

Rescuing Greece would strengthen EU unity by eroding the fiscal autonomy of individual countries

This crisis is a critical test of the resolve of the major euro countries. Should they let Greece sink, thereby undermining the ties that bond the EU countries? Or should they avoid this problem by rescuing Greece? If the decision is made to save Greece, the parties extending support (the EU, Germany, France and others) would assume a supervisory role concerning financial policy in Greece. This is precisely the thesis-antithesis-synthesis process for determining a way to solve the root cause of a problem. The euro has a fundamental flaw. Unification in terms of the currency and financial policies has been achieved. But individual countries are still responsible for their own fiscal policies. As a result, the crisis in Greece is forcing the EU countries to make a difficult decision. They must choose either a unified currency or fiscal autonomy for member countries. This is a true test of the EU's resolve.

Once we have reached this point, the conclusion is obvious. Protecting the single European currency at all costs is the only viable option. Of course, that also means that the financial autonomy of member countries must be sacrificed. By weakening the ability of EU countries to determine their own financial policies, the Greek crisis will ultimately create even stronger ties among member countries. A recovery in the global economy has clearly started. Against this favorable backdrop, financial markets will probably settle down once a rescue package for Greece is announced. This is why I think there is no need to worry too much about this problem spreading to other countries.

A market theory that makes no sense; a revival of risk taking after the technical correction

At times, market participants confidently use excuses that are clearly contradictory. Concerns about sovereign risk are an excellent illustration. We are hearing discussions about the ability of debt-laden major countries to meet their obligations as fears increase about a default in Greece and emerging European countries. There is talk about government bond credit rating cuts for Britain, Japan and even the U.S. This same talk is the basis of speculation about the possible collapse of the U.S. economy. But the reality is different. The crisis in Greece is causing the euro to drop as the dollar strengthens and U.S. long-term interest rates decline. Is this bad news in any way for the U.S. economy? Some people insist that a link exists between the ability of the U.S. government (and Japanese government) to procure funds and risk associated with peripheral European countries. But this is a big mistake. Investors may have been looking for an excuse for a technical correction. The Greek crisis conveniently appeared at just the right time. This is the real reason that many people are overlooking the upturn in U.S. economic fundamentals to adopt the pessimistic stance that problems in Europe are a reason to sell stocks. Or maybe all this pessimism is just an excuse for the trading activities of hedge funds.

This is why I believe that this technical correction will be followed by a continuation in the rally that has been fueled by strong economic fundamentals. There is no change in our original 2010 outlook for a recovery in the U.S. economy, rising stock prices worldwide and a shift to a stronger dollar and weaker yen. If this happens, I think investors will start turning their attention to Japanese stocks.