

My big fat Greek conspiracy theory

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The Greek debt crisis prompts an interesting question: why Greece, and why now? True, successive Greek governments have studiously ignored the principle of fiscal discipline, and even doctored data to conceal their mischief. Suspicion, therefore, is fully warranted, but Greek fiscal laxity is not new. Furthermore, even accounting for accounting slippages, the Greek budget deficit for 2009-2010 is likely to be lower, possibly much lower, than those in the UK and US, according to Organisation for Economic Co-operation and Development projections. Nor is Greek public debt unusual, by current standards. It is about half that of Japan and lower than Italy's. So why Greece and why now? Here is my conspiracy theory.

Greek debt offers a nice return, exceeding by some 3 percentage points the yield offered by German debt. This difference is aptly called a risk premium, reflecting the market's assessment of the probability that the Greek authorities will default and of the size of the default. The Greek government has no intention whatsoever of defaulting and no reason to do so, since its situation is no worse than in many other countries. Yet it may be forced to do so if markets refuse to provide the financing. The first step in my theory is the non-controversial conclusion that the only reason why the Greek government might default is market pressure.

What is troubling is the insistence among market participants that eurozone governments will rescue their Greek *confrère*. It echoes what bankers said after the interbank market seized up in August 2007: the crisis will only end when banks are bailed out. They were right, no matter how immoral the outcome eventually was. We now hear bond markets saying they enjoy cashing in the risk premium but that governments should make sure that the risk never occurs. Taxpayers, once again, are invited to transform a highly lucrative risky business into a safe one.

Why should governments fall into that trap? One popular story is that, while Greece is relatively small – so a default there would not create much of a problem – the real risk is contagion. Markets never miss a chance to warn that Greece would only be the first shoe to drop; Portugal, Spain and Italy would soon follow. This is why, understandably, these governments are ready to bail out Greece. But why should Germany and France join in? Here comes the second step of my conspiracy theory.

Rumour has it that some large German and French banks have a significant exposure to Greek debt. Rumour also has it that the same banks have yet to recognise much of their losses on US subprime mortgages. Now things start hanging together. France and Germany can allow Greece to default, but not some big, systemically important European banks.

However, the moral hazard of bailing out Greece is no smaller than that of bailing out Goldman Sachs, not only because it makes a mockery of fiscal responsibility, but because it amounts to bailing out big European banks that have benefited for far too long from government forbearance. The stakes, again, are huge.

The US Congress recently grilled former Treasury Secretary Henry Paulson and his successor Tim Geithner, as it tries to determine whether they were too generous to banks with taxpayers' money when AIG collapsed. Their defence is that they had precious little time to think things through as they faced the abyss. Fair enough. Their European counterparts have had plenty of time to ponder the very same issue. If they bail Greece out, one day they will have to be grilled too, and they will have no good answer.

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