Misbegotten Entry, but No Exit for Greece

John Williamson suggests that to save the euro area, Greece must deflate but that Germany and some other countries should accept a bit more inflation.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics, with John Williamson, senior fellow at the institute, who has been through more than his share of financial crises, and analyzed them. As the turmoil in Europe continues, Greece faces a possible referendum on a rescue package. Are the Greeks and the Europeans going about this the right way? Should an exit from the euro zone be considered?

John Williamson: I think it would be a last resort. I think it would be unfortunate for the Greeks, and also for the euro zone, if Greece were to exit now. I don't see that they can. This core institution of Europe [has enabled] Europe to remain together in the way that it has been coming together in the post-war years. And hence, I fear that a resort to expelling Greece from the euro zone would be followed by the breakup of the eurozone as a whole. Now, one can't prove that. One can't assert it with certainty, but it seems to me highly likely. And, it seems to me that that would be unfortunate, to say the least.

Steve Weisman: You were suggesting to me earlier that it might have been a mistake for Greece to get into this euro compact to begin with. President Sarkozy hinted he thought the same way, and then everybody came down on him pretty hard.

John Williamson: Well, I think the decision was incorrect, yes. In retrospect, it's easy to say that, because it turns out that Greece was fiddling with statistics and that's why they got in.

Steve Weisman: They were cooking their books.

John Williamson: Right, they cooked the books and now – not the present government; the present government is the one that raised the alarm, and first drew the attention of the world to the fact that the previous government had been cooking the books. But I think one has to admit, in the light of that, that there was much more substance in the fears that differential inflation would be a more serious problem within Europe than, in fact, was allowed for at the time. And hence, the eurozone would have been stronger if Greece had not been in, and come to that, maybe Italy shouldn't have been joined or been a member as well.

Maybe all of the countries of the European fringe should have been excluded. One can argue that. I actually think it's not true of Ireland; I think Ireland made its mistakes of policy. But they were quite strong enough to enter. But the other southern countries, I think a good case could be made that it was a mistake to have them in right at the beginning.

Steve Weisman: For the entire post-war period, we thought of the division in Europe as being East and West. But now you're saying we should have thought more clearly about it being North and South – culturally and politically, if not economically.

John Williamson: I think it was clear that there was a division. There were some Germans who were very much against the Italian entry. In fact, I remember being told quite emphatically that there was no question that Italy would be allowed to join the euro zone. This was the mid-90s, in Washington, by a German. And that view has held, I think in the light of history. It was basically right, that it would have been better if these countries had taken their time and made sure that they were in a good condition to enter before they became members of the euro zone.

Steve Weisman: What is it that defines this difference between North and South?

John Williamson: I think it's basically the willingness to tolerate inflation. In Southern Europe, inflation had been part of the way of life, like in Britain. Britain in fact reformed in the '90s, got out of this habit of inflating too fast, and would therefore in my view, have been in a position to join the euro zone safely. But instead, the euro zone was joined by a number of the Southern European countries that really hadn't put this temptation behind them and, hence there was a willingness – there was high inflation, it wasn't much higher, not as universally high as believed -- but there was a willingness to live with weak balance payment positions and so on.

Steve Weisman: Greece does not in the practical world have the option of exiting the eurozone without causing a calamity throughout the region, you are saying. But what is your assessment of the package to get Greece toward stability? The 50 percent haircuts for creditors, the austerity program in Greece, the use of some kind of instrument to prevent contagion from Greece to Italy and France. What do you think?

John Williamson: I'm afraid that I'm in the school which doesn't think that it's the last word, which doubts very much whether this is going to end the crisis. Although one can see that the individual items were related, still one has to ask whether they're going to succeed. And in the case of Greece, the problem isn't so much the size of the haircut, as getting Greece going again, without the need for faster credit expansion at home, and deficit spending along with the other props that it was using in the past, and which it can't use, resort to, in the future. So, that's my worry about Greece, that the other parts of the package, all the deflations [are] there, but there's still not a restoration of competitiveness of the sort that would have been accomplished by – in most countries – by devaluation under these circumstances.

As far as other countries are concerned, I think it's well known that the present set-up with the European [Financial] Stability Fund is not such as to engender great confidence that this is the ultimate solution. The fact is that it only has a limited amount of money that it can spend, and they talk about bringing in some more money, getting some good investors, so any haircut is borne by the members, the other Europeans, rather than by the outside investors. Even [then], one doubts whether there's going to be a great deal of extra money, and that the IMF couldn't invest in anything like this. It just isn't set up to make loans to the sovereign governments, and not to make loans of this type. So, you couldn't in fact do it through the IMF, which means you'd have to do it through getting individual governments to subscribe, and I don't think the Greeks are going to take that sort of risk with their money, I'm afraid.

Steve Weisman: What about, on the fiscal side? What do you think of the call among some that Germany and the other countries in the North take steps to increase growth, and maybe help Greece out that way?

John Williamson: I certainly think there's a need for faster growth in the Northern European countries. There is case for fiscal expansion where it can be afforded, and that includes Germany. But above all, one is afraid that Germany is going to continue to look at its national rate of inflation, rather than the overall euro rate of inflation, which is considered the appropriate thing for the Europe Central Bank to be looking at. The fact is that, if there was to be adjustment within Europe, it's going to have to involve the other countries deflating relative to Germany, and that can in part be accomplished by having them deflating their price levels, but [it] would be much easier if Germany is prepared to accept a certain increase in its price level [as] part of the adjustment. And that's what I think one should be looking for above all in the stronger European countries – a willingness to participate in the adjustment process by seeing their national rates of inflation increase relative to the European norm.

Steve Weisman: Hard to imagine Germany doing that, though.

John Williamson: You know, Germans are subject to the same logic as the rest of us. They have to face the fact that there are going to be some difficult calls for them, as well.

Steve Weisman: Thank you, John.