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Why Greece Shouldn't Look to Russia for Advice

By Eric Kraus

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Some commentators have argued that Greece should emulate Russia, saving itself by default, devaluation and restructuring — assuming that, like Russia, Greece would quickly rebound, benefiting from a suddenly competitive currency, debt relief and even the renewed ability to borrow in international financial markets. In fact, such advice is almost comically misguided, based upon a failure to appreciate the fundamental differences between the two countries.

Like Russia in 1998, Greece is currently faced with a debt crisis, an inflexible currency regime and a largely unreformed economy with a dysfunctional tax system. The similarities, however, end there. Russia had a population 15 times that of Greece, as well as a legacy of Soviet industrial infrastructure almost entirely autonomous from the West. Following the 1998 devaluation and default, the plunging ruble rendered Soviet-era industry suddenly competitive as imports were squeezed out, with Russia benefiting from a deep internal market and complete self-sufficiency in vital resources, in particular energy.

Following the 1998 crisis, as foreign products were priced out of the domestic market, import substitution fueled growth in industrial output. Then a surge in oil prices coupled with the economic orthodoxy of Vladimir Putin's government resulted in the "twin surpluses" — both the budget and the current account swung into huge surplus as the state wrested a lion's share of oil export revenues from the oligarchs.

Vitally, Russia never defaulted on its eurobonds. The 1998 default was limited to domestic ruble debt; the eurobonds were faithfully serviced — even during the depths of the crisis. As a result, there were few if any investor lawsuits attempting to seize Russian foreign assets. Contrast this with Argentina, which has been hamstrung by court actions conducted by the holdouts who have refused to accept the debt restructuring. Eight years after its own default, Argentina is still precluded from issuing foreign debt by the fear of seizure of the proceeds by New York courts.

Greece, of course, has no "local currency" debt to default on — it is all bonded debt, and any failure to pay would cause a cross-default of all Greek assets. Greece lacks any substantial consumer goods industry, natural resources or the ability to simply close the borders and function on the basis of domestic resources alone. Greece must continue to import energy and vital foodstuffs, and thus requires access to global markets. With a population of just 10 million, it is no more likely to suddenly show a surge in industrial production than it is to miraculously develop Russia's massive hydrocarbon reserves or Argentina's rich agricultural lands and massive soya exports.

While unarguably entertaining, the blame game is singularly useless. Greece was for all intents and purposes a Third World economy as late as the 1980s, but its accession first to the EU and then to the euro zone led to an explosive increase in apparent wealth without corresponding structural reforms. Adopting the euro in 2000 allowed Greece to embark on a wave of borrowing, essentially at German interest rates, funding explosive growth in imports of consumer goods and military hardware, again largely from Germany. During a recent visit, I found the Athens taxi fleet more modern than Frankfurt's — comprised largely of late-model Mercedes. The Siemens scandal demonstrated payment of tens of millions of dollars in bribes to facilitate some of these sales (story).

Like Russia, Greece has a history of resisting the tax collector during a Muslim domination and like Argentina, a political system based upon clientelism, nepotism and "Peronism" — the purchase of social peace via generous government employment. With Russia and Argentina, Greece shares a serious problem of corruption. Greece has little industry, limited agricultural land, and gross domestic product is based on tourism, shipping and services, none of which would see much benefit from a devaluation.

While the Russian default ultimately proved less devastating than predicted, the global financial system was far less closely interconnected at the time. Even so, it triggered the collapse of the hedge fund Long Term Capital Management. Only the rapid intervention of the New York Federal Reserve prevented the sort of crisis seen a decade later when Lehman Brothers went to the wall. While bailing out Lehman before the fact would have been expensive, the price would have been trivial by comparison with the ultimate costs of repairing the damage — costs that will continue to be paid for years to come.

A default by Greece would be more damaging to the global economy than was Lehman's. The reason stems not so much to the magnitude of the Greek debt — a manageable 312 billion euros, or slightly less than the amount the United States has written off on the bailouts of mortgage giants Fannie Mae and Freddie Mac — but to that bane of modern finance: the contagion effect. Were Greece to default on Monday, by Wednesday Ireland and Portugal would have joined it and by Friday the barbarians would be storming the gates of Madrid. Those who imagine that the havoc would be confined to Europe would have a nasty surprise. Much as the European finance sector was devastated by the 2008 U.S. subprime crisis, the United States is now at the mercy of events in the Old World. According to Fitch Ratings, fully 50 percent of the assets of U.S. money market funds are held in the commercial paper of European banks, while the credit default swap exposure of U.S. banks is estimated at $1.5 trillion.

Germany and its northern neighbors face two alternatives: an expensive bailout, or a far more expensive split of Europe into two broken moieties. Although the German popular press is replete with invective about the Greeks partying thanks to German largesse, the truth is more nuanced. The major beneficiary of the euro was Germany itself, which in a model akin to the Chinese vendor-finance of debt-fueled U.S. consumption has benefited from a large European market for its industrial exports. If a deep and prolonged recession in Southern Europe would indeed be damaging for German industry, a disorderly exit from the euro would prove ruinous.

With the wisdom of hindsight, it is obvious that the inclusion of Greece in the euro was an expensive error motivated by misplaced ideology. Monetary union without fiscal and economic integration is destined to fail. Thus, Europe faces a stark choice: either an inexorable drift into financial crisis and a breakdown, or a gradual move toward greater federalism. Despite the obvious political difficulties, there can be no question but that the second option will prevail.

This is fortunate for the Greeks. In the aftermath of a default, Greece would be Russia without the oil and resources, or, perhaps more accurately, Argentina without the soya bean crop. The Greek banking system would be wiped out, the country would be unable to pay for vital imports, and given that Marxism has not been discredited in Greece as it has been in Europe or Russia, the political outcome would be unpredictable. From a global perspective, the primary difference is that while both Russia and Argentina could default with limited impact upon the global financial system, a Balkan country of some 10 million inhabitants now credibly threatens the world with a resumption of the 2008 meltdown. For the EU to simply pay down Greece's debt would be cheaper than trying to repair the damage. And yes, once the firemen leave, the architects may wish to get to work restructuring a global financial system now best described as an accident going somewhere to happen.

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