

The Grexit fallout

With the impending Greek default, the future of globalisation—and all the efficiencies and welfare benefits it brings—is at stake. Other nascent regional groupings, and above all the G20, are watching with bated breath



ALOK SHEEL

The fear of Grexit and Greek default continues to hang by a solitary hair of a horse's tail over global financial markets like the Sword of Damocles. This is, in essence, a battle between the past and the future, between the nation state and globalising forces.

The eurozone question virtually hijacked the agenda of G20 leaders at their sixth summit in France in November 2011. A band-aid was put on the sore. The can was kicked down the road through bailout packages that bought time rather than resolution. Over three years later, the crisis continues to fester despite the proverbial can being kicked down the road several times, effectively transferring liabilities from private creditors and banks to official creditors. The latter now stand to lose the most from Greece defaulting on its debt.

The continuing crisis in Greece is but a symptom of the wider problem, namely birth defects in the design of the Economic and Monetary Union (EMU) of the EU forged a little over a decade and a half ago. These fatal flaws were well known, but the union was more a political than an economic project.

A monetary union has several advantages, just like any large integrated economy, such as the US or the Indian federation. However, as Robert Mundell pointed out over five decades ago, it needs at least four essential features to be optimal—capital mobility; economic integration that makes for synchronised business cycles so that there can be a single monetary policy; labour mobility; and automatic fiscal transfers ring-fenced by hard budget constraints. With constitutional restrictions on the constituent state's borrowing powers, the US and India by and large fulfil these requirements. The eurozone does not.

With the benefit of hindsight, one could perhaps add two more essential ingredients. One, a banking union that cuts the umbilical cord between banks and constituent countries. With operations across multiple countries in the union, the assets of several European banks exceed the gross domestic product of their sovereigns, making them too big to be bailed out.

Two, convergent productivity that makes for an equitable exchange rate. In terms of the Mundell-Fleming Framework, each country or state in a monetary union is subject to a common exchange rate and capital mobility, but does not have monetary independence. The European Central Bank (ECB) sets monetary policy in the eurozone. In such a situation, nominal rather than real wage adjustments are necessary to improve competitiveness. This is always politically difficult.

Greece joined the EMU in 2001. Its borrowing costs fell sharply as the drachma gave way to the much stronger euro, a reserve currency, allowing it to increase consumption. Its current account deficit shot up from 3.4% of GDP to over 5% almost immediately. Its external deficits kept rising and exceeded 10% by the eve of the global financial crisis, peaking at around 15%. The story was repeated in Spain, Portugal, Ireland, other members of the PIGS club. Meanwhile, Germany went from a deficit to a surplus that consistently exceeded 5% of GDP. The same exchange rate led to vastly different outcomes in the two countries because of productivity differentials and poor labour mobility. The euro did not depreciate because the eurozone as a whole was balanced. PIGS deficits were counterbalanced by northern surpluses.

What happens when a country persistently runs large current account

deficits? One is tempted to conclude that as external liabilities accumulate as a consequence of the need to finance these deficits, a point would be reached when the confidence of those financing the deficits would disappear. At first the cost of financing would rise through credit downgrades, further exacerbating the deficit; then, when the Minsky moment comes, external confidence crashes altogether and the currency collapses as market access is lost. This is exactly what happened to the clutch of eurozone countries described by the colourful acronym PIGS. Greece is the most extreme example, but Grexit can be expected to spill over to other vulnerable countries in the eurozone.

Textbook Macroeconomics 101, one might say? Except that the outcome depends very much on where you are coming from. The above sequence of events would surely happen if you were a developing country, resulting in a localised, or at worst a regional crisis like the East Asian Crisis of 1997. But the global economy and financial markets would carry on as usual. However, if you are the

issuer of the global reserve currency, the large external demand for the currency might ensure that the Minsky moment never arrives, despite any credit downgrade that rating agencies might make. This is what happened to the US and the dollar during the global financial crisis. The IMF had long warned of a global financial crisis stemming from a disorderly unwinding of US current account imbalances and resulting in the collapse of the dollar. The financial crisis did occur; but not in the manner forecast. When global financial markets went into a tailspin, the ensuing flight across the board actually strengthened the dollar despite the source of the crisis emanating from the US.

Even if there were a Minsky moment for the US, and the dollar were to collapse and borrowing costs to rise, it can always avoid a technical default because the debt it owes to non-residents is denominated in its own currency. There is no difference between its external and domestic debt. Sovereigns can always print their way out of domestic debt. This might cause macro-economic instability, but a default can be avoided.

Greece's debt is also denominated in its domestic currency. However, since it does not have monetary autonomy, it cannot print its way out of default, or depreciate its currency to match its productivity. Only the ECB can print the euro. In such a situation, fiscal transfers are required to avoid default. The absence of such a mechanism is the biggest birth defect of the eurozone.

Technically speaking, Greece has not voted for Grexit in the recent referendum. It has voted to reject a compromise with international creditors. Grexit and international pariah status, and possible expulsion from the wider 27 member EU, is nevertheless likely. The vote will be interpreted as wilful default, especially since it has already defaulted on IMF repayment, and because the biggest creditors of Greece are now official, the IMF, the ECB and the sovereigns of the bigger eurozone countries such as Germany, France, Italy and Spain. Their politicians, and in particular Angela Merkel, are likely to suffer politically from the fallout of the Greek crisis.

What the eurozone politicians were trying to do was shut the stables after the horses had bolted by denying debt restructuring or/and further assistance to Greece. It is their taxpayers who stand to lose most from a Greek default. European politicians are complicit in bailing out private creditors and banks who lent recklessly and transferring their liabilities to taxpayers without being forced to take haircuts. Now the taxpayers will be forced to take the haircuts because Greece cannot repay its debt in full.

At current growth rates, Greece had little option but to default on its liabilities without harsh and painful reforms. Merkel, the most influential European leader, recognises this and is willing to consider debt restructuring provided this results in effective fiscal and banking union. This would mean a hard budget constraint on constituent states through curtailment of sovereignty. It would, at the same time, once and for all correct the birth defect of the eurozone.

With euro funding ending, Greece has little option but to exit the eurozone and restore the drachma. This would mean a great deal of front-loaded pain for the Greek population, but will it lead to another international financial crisis? Ironically, despite all the post-crisis attention on financial institutions too big to be allowed to fail, neither the global financial crisis nor the eurozone crisis emanated from too big to fail entities. The US sub-prime housing market was a relatively small segment of the very

deep US financial markets. Greece is less than 0.5% of the global economy. The greater danger lies in contagion.

In the case of the global financial crisis, opaque, complex structured financial products distributed through shadow banks made it impossible to determine on whose balance sheets the defaults would show up. This led to a generalised risk aversion in global financial markets and a credit freeze.

In the case of Greece, it is quite clear where the risks lie. The earlier bailouts transferred major Greek exposures to official creditors—Germany, France, Italy, Spain, the IMF and the ECB. But there are several slow-growing eurozone economies with high levels of sovereign debt that can be serviced only as long as interest rates remain low. A Minsky moment can change all that. As borrowing costs increase, existing levels of debt would look increasingly unsustainable. Any contagion from the Greece crisis can snowball beyond the PIGS to expose Italy and even France. The only way this can be prevented is by the ECB stepping up its QE programme and buying bonds of weaker eurozone countries.

Grexit might give Greece immediate fiscal and exchange rate flexibility to kick-start a recovery, but at the cost of great front-loaded pain. My best guess is that despite the IMF default and the referendum, the can will somehow be kicked down the road again to buy more time. The eurozone is, however, skating on thin ice. Sooner or later Grexit, and more, seems inevitable unless all stakeholders in the eurozone project summon the political will to fundamentally redesign it to move towards greater fiscal and banking union, which implies a further curtailment of sovereignty. The future of globalisation, and all the efficiencies and welfare benefits it brings in its wake, is at stake. Other nascent regional groupings, and above all the G20, are watching with bated breath.

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OVER THE BARREL

Chasing scandals and TRPs

'Lalitgate' is an act of monumental political indiscretion. But the media appears to have mistaken vigilantism for responsible investigation



VIKRAM S MEHTA

I recently returned to Delhi after several days at my home in Binsar—a remote forest and wildlife sanctuary in the Kumaon hills. It is almost totally cut off. There is no electricity, and although some of us who can afford the upfront capital costs of solar have brought lighting into our homes, the modern accoutrements of connectivity—internet and TV—are generally unreliable. The roads are pitted and narrow and there is no delivery of newspaper or other print information. I have to walk the last half kilometre to my place. I have, in short, been shielded from the cacophony of the plains.

So maybe you can imagine my sinking feeling of *deja vu* when I switched on the TV and came face to virtual face with 'Lalitgate'. The same anchors, the same profile of panelists, the same noisy and often incomprehensible exchange, and the same subject of political impropriety and corruption that had been the fare for so much of the UPA regime. I could not help but wonder: What has changed since then? Are we now about to experience another bout of paralytic government? Will Parliament once again become a venue for sloganeering?

I am stuck on the horns of a dilemma. I support media's efforts to bring to the surface political impropriety and corruption. Yet I worry that the line dividing responsible investigation from vigilantism has got blurred, and that, in its single-minded and at times almost maniacal pursuit of TRP ratings, it crosses this line without even realising it. And that when it does, it subverts rather than enhances public interest.

Lalitgate is undoubtedly an act of monumental political indiscretion and hubris. I cannot understand why the chief minister of Rajasthan signed an affidavit that is so self-incriminating. Or why the foreign minister risked controversy by putting her weight behind

Lalit Modi's application for travel documents. But equally, I cannot fathom why the personal shenanigans of this man have warranted prime-time TV coverage for over three weeks now. Is this a subject of such unremarkable national significance? When Arnab Goswami pronounces that the "nation wants to know," I wonder what the geography of his 'nation' is. It certainly does not cover the villagers in the Himalayan fastness of Uttarakhand. They do not give a whit about Lalit Modi. What they want to know is whether the government they elected to power will deliver on its promises. What they want is for Goswami and his ilk to use their investigative powers to keep the government on track for such delivery.

I understand the importance of investigative journalism. I am glad the news of Lalitgate was broken and I am also glad that, because of intensive coverage, there is no way it can be swept under the carpet. But I do believe that by continuing to provide Lalit Modi a public conduit to tweet his personal vendettas, the media is distracting public attention from matters of far

greater significance. We need to remind ourselves that barely 15 months ago the economy was on the skids. Growth had slipped to 5% and inflation was running at 10%+plus. Although the then finance minister, P Chidambaram, had successfully clamped the brakes and the fiscal and current account deficit numbers were trending in the right direction, the finances of the government were not robust. The corporate sector was also moribund. Public and private investment had slowed from around 36% of the GDP in 2010 to below 30%, and the incremental capital output ratio (a measure of efficiency) had increased from 4:5 to over 6. The latter was because of poor infrastructure, rising input costs, bureaucratic paralysis and the disconnect between political and economic governance. The national mood was despondent.

A year into the government, no one can claim that all is well but most will admit the damage has been substantially repaired. Food inflation has been brought under control; quality of expenditure has improved; coal produc-

tion is showing double-digit growth; several projects have been unclogged from the maze of bureaucracy; and there is renewed vigour in public sector investment, especially for the railways. Also, many good ideas conceptualised by the previous government but not implemented, like the goods and services tax and the direct benefit transfer, remain firmly on the policy anvil.

The question is whether the government will be able to continue with this repair job and place the economy back on the high-growth trajectory. Will it be able to garner the political support to take the next steps? This question needs to be asked because the economic imperatives to keep moving are huge. There are the systemic problems of unemployment, poor quality education, mismatched skills, inadequate health facilities and crummy infrastructure. But over and above that there is the issue of under-capitalised public sector banks, tepid credit offtake and a still cautious private sector. Credit rating agency Moody's has once again raised a flag of forewarning. A policy stall at this stage could reverse the gains made in the past year and foreclose an early return to sustained growth.

Against this economic backdrop, the media should reflect on whether, in its single-minded drive to maximise TRPs, it is in fact subserving the hopes of the millions who voted for a change of government last year. This is not to suggest that the media ignore its commercial interests. It must chase news that draws public attention, and it is understandable why it focuses on politics. It offers rich pickings. This is to suggest simply that it stay on this side of the line and not arrogate to itself the role of judge and jury of proper political conduct. We have courts of law and the electoral commission. It is for them to determine if an elected leader has crossed the bounds of legality and, if so, what the sanction ought to be. This is to suggest that the media not become an accomplice of those who want to hold public governance hostage to narrow private agendas.

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Can the postal bank make a difference?

It must establish presence in the rapidly developing retail payments market

DHANANJAY BAPAT

It is likely that RBI will grant payment licence to the postal department by August 2015. For years the postal department is serious about entering universal banking services. In fact, top management officials of the ranks of post master general and directors even underwent training at national banking institutes in 2006.

The journey towards the entry involved twists and turns. Although the roadmap was prepared in 2013, the proposal was opposed on the grounds that the department does not have desired credit management skills—one of the essential functions of a bank.

The proposal was not cleared even in 2014 at a time when Bandhan and IDFC bagged licences to set up a bank. But the situation has undergone a change. The current entry is likely to be as a payments bank wherein it will be restricted to demand deposits subject to a prescribed limit and will be allowed to issue ATM-cum-debit cards and prepaid card instruments, but not credit cards. The moot point is, how can it offer sustainable value proposition to its customers and stakeholders and how will its business model be distinctive?

Doubts have been raised about its success since it had a deficit of ₹5,473 crore by 2013-14. Another concern is whether its entry as a payments bank contributes in reducing the deficit?

Postal banks exist in countries such as Germany, Tanzania, Japan and Sri Lanka, etc. In fact, they have been major players in retail banking globally and are able to leverage the core strength of distribution and customer portfolio. In terms of assets for 2014, the Japan Post Bank is ranked ninth globally, ahead of JPMorgan Chase and Royal Bank of Scotland, among others. It has a strong presence in the savings market and its credit products include overdraft which is secured majorly by time deposits. In addition, it offers credit cards.

The postal department is entering at a time when payments business is showing encouraging prospects—public sector banks (PSBs) face shortage of capital

and are severely affected by NPAs, private banks are performing, and non-banks are knocking the doors of banking business. Although PSBs could have leveraged their nationwide presence, the credit showed favour to the corporates despite the fact that retail banking in India offered significant prospects. For example, the contribution of personal loans for PSBs was 15% and for private banks it was 27% in 2013. Also, urban cooperative banks with a focus on mobile banking exhibit higher mobile banking transactions than some PSBs.

Payments business plays a critical role in banking and contributes to stability and lower capital needs. During difficult times, it acted as a shock absorber, as seen during the global financial crisis. A study suggests that a country with an overall payment efficiency is better placed than islands of excellence by select institutions. Payment business has implications on macroeconomic consequences and trade growth. Banking is undergoing major transformation in which payment business will continue to play a crucial role.

While network and trust continue to be strengths for the postal bank, there is a strong need to focus on payments bank success factors. The postal department, by 2013-14, had a sizeable business of ₹6,15,021 crore from savings bank schemes that include National Savings Certificate, Kisan Vikas Patra, savings account, recurring deposit account, etc. In a study done by this author, based on top management employee perceptions of the department, it obtained low ratings for aggressiveness, innovation and speed. Trust and convenience emerged as critical success factors for its entry into the banking business. Given the challenges faced by the postal department and its possible entry as payments bank, it is suggested that the postal bank follow an effective digitisation strategy supported by strong governance and enabling environment in order to make a visible presence in the rapidly developing retail payments market.

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