First Trust
ECONOMIC RESEARCH REPORT
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Greece is Detroit, Not Lehman

Greece is the land of misinformation. We constantly hear that a Greek default will cause a market panic and be as damaging to financial markets as the default of Lehman Brothers back in 2008. While there is no possible way to know for sure, we believe that a Greek default will look and feel more like the Detroit default. In other words, it may make a great deal of noise, but the European economy will not collapse. In fact, we believe any sell-off in the equity markets is a buying opportunity.

We believe this for five reasons:

First, as long as you weren't in hibernation this past winter, or even during the past 2000 years, Greek financial problems are not new. Economic authors, Reinhardt and Rogoff calculated that since it became independent in 1829, Greece was in default or rescheduling its debt 51% of the time through 2006. This most recent crisis started in 2009, so financial markets have had plenty of time to prepare. In contrast, the Lehman collapse was totally unexpected, mostly due to people believing government would handle it like Bear Stearns.

Second, and some may not know this, Greek GDP (approximately $240 billion in 2013) is roughly equal to the Detroit Metro Area's GDP ($224 billion in 2013). At the same time, European Union GDP is roughly equal to US GDP. In other words, the impact on the EU and on the world will be minimal. Yes, Greece has more debt than Detroit, but markets are prepared.

Third, Greek debt is a "sunk cost." For economic growth it is a moot point. The money has already been underutilized, growth has already suffered. The only thing left is for the realization of losses to rearrange balance sheets. Some banks may take losses, but the money does not disappear – it's already been spent by retirees and the Greek government. The European Central Bank can count it as money creation, which will lead to more inflation over time. The IMF will take a loss, but a smaller IMF would actually be good for the world.

Fourth, the idea that other countries (Spain, Portugal or Italy) will decide they can default, too, is highly questionable. A default would bring added pain to the Greek economy, which is already devastated. No other country will want that. The true "moral hazard" would occur if Greece were bailed out without major budget and pension reform. Then, other countries could use the same strategy to get money and bailouts for themselves.

Finally, think about where many of these arguments are coming from. Keynesians tell us that government spending will increase growth. Then, when that doesn't work, and an economy is teetering toward collapse, they say if we don't bail it out the rest of the world is at risk. Heads, government gets bigger; Tails, the private sector gets smaller.

Robert Mundell, who invented the Euro, hoped that it would impose fiscal discipline on European countries. This would happen because they could not devalue their currency and hide problems with inflation. For the record, inflation doesn't help anyone – it lowers living standards by reducing purchasing power. But, it does get the government off the hook for actually having to cut budgets, payrolls and pensions. The people who are hurt by this tend to get angry at the politicians who do it. Inflation is a more circuitous and hidden tax and lets politicians off the hook.

While the Euro didn't stop Greece from borrowing its way into bankruptcy; it is finally imposing Mundell's discipline. If the EU does the right thing, and forces true austerity or allows a default, then the Mundell hypothesis about a single currency will be proven correct. This could be the best thing that ever happened to Europe. Stay tuned.

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