

Protection vs. Production: What Greece Means to Us

March 26, 2010

What does Greece mean to us – here in the US? How can a country whose GDP is 3% of the Euro Group's and less than the sales of Wal-Mart have any impact on us? Will it amount to a non-event now that the EU appears to have agreed to help it fund its short-term debts? Is it a subprime crisis – something smaller leading to something bigger? Or is there deeper meaning for us? We believe the latter. We compare Germany, Greece, and the US over the past 10 years from various angles. In many respects their economic evolution is remarkably similar such that Greece does not obviously stand out as the egregious basket case it has become. If anything, the US has shown more variability in its recent economic results from its 10-year averages especially with respect to government spending. However, as we dig deeper we notice a theme common to all three countries and that is the dominance of debt-financed government deficit spending as the main driver of GDP increases over the past 10 years. To a striking degree the growth of each country's "sales" – which is what GDP represents – has been overwhelmingly dependent on one-time, debt-funded government spending rather than on the recurring spending that flows from people buying what they want produced from the private economy. Put another way, spending associated with government-provided protections have dominated spending associated with private-sector production. In that sense, the US and Greece (and Germany) resemble each other much more closely than is appreciated. That Greece is in an economic storm should serve as a clear warning to the US, which is headed in the same direction.

What's Greece to Us?

"What's Hecuba to him or he to Hecuba?" said Hamlet – asking rhetorically why an actor playing Hecuba got so involved with a mere fictional character?

And I ask and I know many of you ask, "what's Greece to us and we to Greece?" What's the big deal when Greece's €246 billion GDP represents less than 3% of the Euro Group's €9,093 billion GDP? See Exhibit 1. Or, when in dollar terms, its GDP at \$332 billion is less than Wal-Mart's \$405 billion sales for 2009? More importantly, like Hamlet, we've got our own problems. What does Greece have to do with us, here, now?

GDP		2009
Euro Group	€	9,093
Greece	€	246
Greek Govt. Debt	€	246

There is a debt problem...

Of course, as Exhibit 1 also shows, Greece has existing government debt of €246 – by chance the same number as its GDP – and it's having trouble rolling over and repaying that debt. That's true...

And if the latest bailout efforts of the European Union just announced yesterday (March 25) don't gel, or if they only succeed in getting Greece through a temporary funding emergency in April and May but then break down, it *is* possible that the crisis could re-erupt and affect us.

As Dennis Lockhart, President of the Federal Reserve Bank of Atlanta succinctly put it on March 22, a full-blown Greek crisis could affect the US in one of three ways:

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

- It could dampen euro growth;
- It could shift demand from euros to dollars; and
- It could make all sovereign debt suspect and shake the financial markets.

All true.

But...this is no subprime situation

For one thing, Greece is a government not an insolvent homeowner. It **can** tax its citizens. It **can** cut back its government spending until it has enough left over to start paying down debt. It **can** call in the IMF and, if it does, it **can** put its outstretched wrists into the handcuffs of the IMF and let the IMF impose the same tax and austerity measures it has for over its 66-year history to dozens of countries many of them far worse cases than Greece.

Further, unlike subprime loans which were cut up and scattered like bits of dried dates in those complex, opaque, holiday fruitcakes called Collateralized Debt Obligations or CDOs and their virtual fruitcake cousins CDO-squareds, Greek government debt is made up of straightforward, discrete pieces of debt of different maturities that heretofore have been so easy to offload that a bank owning some could present the debt to the European Central Bank (ECB) and with a small discount (growing larger, the longer the maturity) and the promise to buy the debt back, receive hard, cold euro cash in return – all at the same rate and terms as German government debt!

Greece does owe outsiders...

OK, I know there's more to it.

I know for instance that most of the €246 billion of government debt is owed to non-Greeks. I know most of those non-Greeks happen to be German and French banks.

I know that, up until recently, they have liked their good old Greek debt. They could get higher rates of interest than other European government debt, and rest very satisfied that the European Union was not going to ever let Greece default.

After all, if the European Union just told Greece to go ahead and default, these same German and French banks would have to take big write-offs on their Greek debt – which in turn would become a domestic financial crisis for Germany and France. Would the big European governments **really** let Greece default only to have to turn around and bail out one of their banks?

Are extreme scenarios plausible?

Or, to take an even more extreme scenario, would the European Union – as German Finance Minister Wolfgang Schäuble hinted it might in the *Financial Times* on March 12th – boot Greece permanently or temporarily out of the euro? Would it risk Greece returning to the drachma and perhaps repudiating some or all of its euro debts by converting them into drachma debt? Would the authorities tolerate German and French banks being stuck with drachma bonds, formerly Greek eurobonds? And if they did, what about the banks that hold Portuguese, Spanish, Italian and Irish bonds? Would the EU authorities risk banks across Europe writing down, or even threatening to have to write down, government bonds of other financially weak governments?

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

The answer is...

All these questions point to an obvious answer: the Greek crisis for Europeans, at least, may have something to do with the “prestige” and other benefits of maintaining the euro but the prestige and benefits of maintaining the Euro have a lot to do right now with **not** letting European banks write down very large amounts of debt and eroding public confidence in them. The pressure to maintain the euro is inextricably tied up with the pressure to maintain a solid banking system in a nascent economic recovery.

A longer-term meaning

But all of this, while true and important in the moment, is not to me the longer-duration and deeper meaning of Greece, not just to the Europeans who have a clear and present vested interest in the short-term outcome, but to us, over here, in the USA. Because there **is** meaning to us – and its meaning is, in my view, big.

So, as they say, “listen up!”

Replaying the movie

Let us go back to the good old days of 1999. The dotcoms were in full bloom. The air was rich with promise of new eras ahead. Dress-down was a badge of being in touch with where the wealth-puck of the future was going to be. The best and the brightest sniffed at the “old economy”. “Goodbye Burlington Northern! Hello, virtual world!”

It was by the end of that year that Greece recorded nominal GDP of €123 as you can see in Exhibit 2. And by the way, throughout most of this piece I am deliberately using **nominal** GDP – that is GDP **with inflation baked in** because it is **nominal** GDP that we **experience** whereas real GDP – stripped of inflation – while correctly the true retrospective value of GDP **does not capture how GDP felt to economic participants**.

Exhibit 2				
Ten Year Increase in Nominal GDP				
Billions of € or \$				
		<u>1999</u>	<u>2009</u>	<u>Increase</u>
Germany	€	2,012	2,356	344
Greece	€	123	246	123
US	\$	9,354	14,266	4,913

A good 10 years for Greece, nominally speaking

And little Greece did quite well over the next 10 years, or so it seemed (see Exhibits 2 & 3). Compared with Germany and the US – the two comparator countries I'll be using – Greece's GDP did very well. It rose 99% -- adding €123. Germany's rose 17% adding €344. The US' rose 53% adding \$4,913. On a **per-year** basis, over that 10 years, Germans experienced GDP growth of 1.6%, Americans 4.3%, the Greeks 7.2%. It felt good to be a Greek.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

Exhibit 3			
10-Year Change in Nominal GDP %			
		1999-2009	Per Year
Germany	€	17%	1.6%
Greece	€	99%	7.2%
US	\$	53%	4.3%

Inflation can't be ignored

Of course, experience is not necessarily truth and there is this phenomenon called inflation which deflates reality somewhat, so I have to bring it into our story. In Exhibit 4 you see how much GDP growth was inflated by inflation and therefore how much you'd have to deflate it to get to the truth.

Exhibit 4			
10-Year Change in Nominal GDP %			
		1999-2009	Per Year
Germany	€	9%	0.8%
Greece	€	40%	3.4%
US	\$	27%	2.4%

And what you see is that Germany's 17% 10-year GDP growth has to be deflated by 8% to get to the truth – **real** growth. Greece's 99% GDP growth has to be deflated by 40% and the US' GDP by 27%. But **even after inflation – Greece beat them both**. It grew at 3.4% in real terms. Second, came the US at 2.4%. Way behind were the Germans at 0.8%.

And then there's unemployment

I don't blame you for wondering "how the heck did Greece get itself into this mess when it was doing so well?" Well, just wait. There is more. There's unemployment. Maybe Greece did something unusual here that explains its good GDP numbers. But as you see in Exhibit 5 Greece's unemployment was high but unexceptionable.

Exhibit 5			
Average 10-Year Unemployment Rate %			
		1999-2009	2009 Only
Germany		8.6%	8.0%
Greece		9.9%	9.5%
US		5.4%	9.3%

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

It was somewhat higher than Germany's and both countries' unemployment at 8-10% was a lot higher than the US' 5%+. But the Greeks were steady. In 2009 their unemployment was 9.5% just about at the 10-year average of 9.9%. The Germans were close to their average too. Only the US had a big change – from 5%+ to 9%+.

Most of the above can be explained by Europe's less flexible and the US' more flexible labor markets. But the point here is that there is nothing in the unemployment rate that was at odds with a relatively good story for the Greek economy.

And government spending...

"Well", you say, "what about the government and all its spending?" As you'll see we're getting closer to something important but the data do not sound huge alarms for Greece at least. See Exhibit 6. For 10 years Greece's government spending as a percent of GDP averaged 45%. In 2009 – *a few months before the crisis* – it was only 46%! Would that variance put you on high alert? I think not.

Exhibit 6		
Average Government Spending As % of GDP		
	1999-2009	2009 Only
Germany	47%	47%
Greece	45%	46%
US	33%	38%

By the way, and reinforcing what I just said, Germany's government spending as a percent of GDP averaged 47% and in 2009 was 47% -- 1 to 2 percentage points above Greece's! What is the big worry?

Although it is the US that stands out...

If you want to worry, look at the US.

Its government spending averaged 33% for 10 years. But by 2009 it had jumped **to 38%** of GDP! Let's repeat: **the US' government spending jumped 5% above its 10-year average** in 2009.

Greece's spending was only 1% above its 10-year average. Germany was flat with its 10-year average.

Of course, US government spending rose from 32% to 33% to 35% to 38% from 2006-09 because of a conscious policy to keep economic demand going as the financial crisis unfolded and it is possible it will revert back to the 31% level it was at in 1999.

But the rise is sufficiently large, the stickiness of spending sufficiently likely if past experience is any guide, and the probability that fast economic growth will appear in the next decade to lower spending-to-GDP sufficiently unlikely that this jump in US spending cannot just be written off as a mere passing emergency measure.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

Flat revenues

So what about government revenues – what the government was taking in. We hear a lot about how the Greeks don't pay taxes on a lot of their income, the part they earn in the black market economy. Here's what the numbers look like in Exhibit 7.

Exhibit 7		
Average Government Revenues As % of GDP		
	<u>1999-2009</u>	<u>2009 Only</u>
Germany	44%	43%
Greece	40%	40%
US	29%	27%

You certainly can't accuse the Greeks of inconsistency. Over 10 years, the government's revenues averaged 40% of GDP. In 2009 it was 40%. Germany dipped a bit: a 10-year average of 44% of GDP for government revenues falling to 43% in 2009. The US' government revenues fell the most: from a 10-year average of 29% to 27% in 2009.

With deficits, we're getting warmer

Well, it's already obvious from just eyeballing the last two exhibits that there **was** a bit of a deficit problem for all three governments – more spending than revenues.

Exhibit 8		
Average Government Deficit As % of GDP		
	<u>1999-2009</u>	<u>2009 Only</u>
Germany	2.1%	4.2%
Greece	5.1%	6.4%
US	3.4%	12.5%

Government budget deficits as a percent of GDP worsened for all three.

Germany's deficit enlarged from a 10-year average of -2.1% to -4.2% of GDP in 2009.

Greece had the largest 10-year average of -5.1% but it enlarged the least – to -6.4%.

And look at the US. With a 10-year average deficit of -3.4% -- about halfway between Germany's and Greece's – it jumped by far the most in 2009 to from -3.4% to -12.5%.

But percentages don't really convey the reality of what happened. You need to look at **actual**

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

euros and dollars as we do in Exhibit 9. Here we look at the actual **cumulative** 10-year deficit run up by these governments.

Exhibit 9		
10-Year Cumulative Amounts In Billions of € or \$ 1999-2009		
		Government Deficit
Germany	€	538
Greece	€	99
US	\$	4,957

Deficits and debts

Not surprisingly, if government deficits went up by these amounts you would expect government debt to go up by at least these amounts or more – because governments borrow in anticipation of need not just to fund past deficits.

And, in Exhibit 10 that's what you find.

Exhibit 10			
10-Year Cumulative Amounts In Billions of € or \$ 1999-2009			
		Government	
		Deficit	Debt
Germany	€	538	+ 654
Greece	€	99	+ 124
US	\$	4,957	+ 6,411

Germany's 10-year cumulative government deficit was - €538 billion and its 10-year cumulative debt rose by €654 billion.

Greece's cumulative deficit was - €99 billion and its 10-year cumulative debt rose by €124 billion.

The US' cumulative 10-year deficit was - \$4,957 billion and its 10-year cumulative debt rose by \$6,411 billion.

Deficits and debt drive GDP growth

OK, this is expected you say, but now look at Exhibit 11. Here we add a third column to the previous two in Exhibit 10. **We add the cumulative 10-year increase in nominal GDP** from Exhibit 2. Look at these figures carefully.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

Exhibit 11				
10-Year Cumulative Amounts				
In Billions of € or \$				
1999-2009				
Government				
		Deficit	Debt	GDP Increase
Germany	€	538	+ 654	+ 344
Greece	€	99	+ 124	+ 123
US	\$	4,957	+ 6,411	+ 4,913

Start with Greece.

Over 10 years it accumulated a deficit of - €99 billion. It funded that deficit with €124 billion of debt – leaving some extra debt to fund future deficits.¹

That €99 billion deficit was spent over 10 years. And that spending accounted for 80% of €123 billion of increased GDP that was produced by the Greek economy over 10 years. ***In other words 80% of the increase in Greek GDP over 10 years was due to government deficit spending, 20% to other factors.***

And the preponderance of that 80% derived from deficit spending was spent on consumables that disappear once the spending is done, or on other longer-lived items like houses that do not produce any cash that can be reinvested to make the economy grow. See the footnote below on why it is that so little government deficit spending ends up in investments that produce free cash that can, in turn, be reinvested to make the economy grow, thereby increasing the tax base, and reducing the deficit¹.

Creating “sales” with debt

Just think of what this means. GDP is to a country what sales are to a company. Suppose a company borrowed \$99 billion over 10 years. Suppose it gave what it borrowed to its customers. Suppose the customers spent the \$99 billion on the company's products over 10 years and thereby increased its sales by \$99 billion. In the eleventh year, the company would have \$99 billion of debt but no sales – at least from this scheme – unless it borrowed more, gave its customers the borrowings, had them buy its products and started the scheme all over again.

¹We estimate that no more than 10% of government spending goes to fixed assets, and of those fixed assets, some large proportion are not free-cash-producing investments. Free-cash-producing investments are those that produce more cash than they need to replace themselves. That extra – free – cash is the fuel for new investments. New investments are what fuel economic growth. Economic growth is what enlarges the government's tax base and allows it, for the same rate of tax, to take in more dollars of tax. A larger tax base is where the supply of dollars comes from to reduce the deficit. The trouble with Greece – and Germany and the US – is that way too much of a dollar of debt-financed government deficit is spent on consumables or other longer-lasting assets (like houses) that don't generate any free-cash – and, in the case of housing, use it up, for things like maintenance. So while it is true that some percentage of Greek, German and US government deficit spending ends up being used in an investment that produces free-cash for investments that power economic growth and increase the tax base, the amount of new investment-led growth from deficit spending is likely low – at best no more than 10% of the deficit spending.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

If we think of the “eleventh year” as the end of the line, Greece is in the “eleventh year.” Markets won’t let it keep borrowing to fund the customers who buy from Greece Incorporated.

In Greece many of these “customers” are Greek public sector workers and the cash they are given with Greece’s borrowings is paid to them as salaries, pensions, health benefits. It is true that they perform work for the cash and benefits they receive. This work has some value to the Greek economy. The problem is that the work and the spending of those who do the work is being funded entirely with borrowed money and – and this is really important – **there is nothing being produced that can pay back the debt. The borrowed money is spent and gone forever.**

It’s not borrowing. It’s borrowing and not producing.

If the Greeks had borrowed €99 billion, invested all of it in the assets of a business that produced a profit of €9 billion a year, used all the profit to pay down the debt in 10 years, at the end of which they had an enterprise producing €9 billion a year free and clear, with no debt, no one would care about their borrowing.

Greece’s problem is that its government borrowing is going mostly to spending that disappears forever not into assets that can produce an ongoing return which, in turn, can begin to pay down the debt.

The same problem for Germany and the US

And that problem, as Exhibit 11 shows, is not confined to Greece.

Germany’s 10-year government deficit is - €538 billion. It is funded by €654 billion in debt. And it is translating into only €344 billion of incremental GDP – of national “sales”.

The US tells more or less the same story. A 10-year deficit of - \$4,957 funded by \$6,411 in debt and yielding \$4,913 in GDP “sales”.

The Greek comparison with the US is even more striking when one looks at Exhibit 12 which displays the 10-year cumulative current account deficit – which is mostly a trade deficit.

Exhibit 12			
10-Year Cumulative Account Deficit			
In Billions of € or \$			
1999-2009			
			10-Year Debt Increase
Germany	€	+1,058	+ 654
Greece	€	- 240	+ 124
US	\$	-6,082	+ 6,411

Greece and the US both have 10-year current account deficits with the rest of the world that are large. (Germany, the exporter, par excellence, has a huge surplus.) And while there is no direct connection between a government’s deficit (a result of public actions) and the current account

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

deficit (the result of private actions) – large government deficits that translate to spending most of which is consumer spending, does provide demand for imports, and therefore a higher current account deficit, than would be the case without that deficit-driven demand.

Greece is easily dismissed

It is of course easy to see Greece as a marginal example of governmental irresponsibility particularly because of its history of corruption – most egregiously evident in its manipulation of government statistics. In Exhibit 13 *Der Spiegel* gives a summary of how Greece fiddled with its numbers.

Exhibit 13

"Since joining the euro zone, the 16 euro countries have violated the deficit rule, under which net new debt cannot exceed 3 percent of GDP, 43 times. Greece is at the top of the list of violators. Only once did the country manage to push its deficit rate below the magic limit: [in 2006] The Greeks sugarcoated their statistics by including prostitution, black-market trade and gambling in the calculation of economic output. As a result, GDP rose by a stunning 25 percent..."

Der Spiegel, 3.21.10

But focusing on how **unlike** we and Germany are to Greece, does not change the basic message of our three countries' last 10-years of history – and that is the message that **we are driving GDP "sales" and therefore the appearance of wealth with deficit spending funded by debt.**

The meaning of Greece to Us

What's Greece to us, and we to Greece? Greece to us is a warning. It is headed where we are going. And as the Chinese proverb says: "If we don't change the direction we are headed, we will end up where we are going."

Yes, for all sorts of reasons we are an incomparably stronger, more varied, and more productive economy than Greece's and therefore we are in a better place now and potentially for the future. But don't confuse size and strength with vulnerability. A deadly disease can kill strapping adult and child alike.

The Greek model is the model Germany and we are following – more public sector borrowing to fund our GDP sales, rather than savings or borrowing to fund assets that produce sufficient returns on which true wealth is built. The fact that Greece has played around with its statistics doesn't change this fact. It doesn't change the general direction of the numbers in this piece – it just makes their implications worse for Greece.

Protection vs. production

And this leads to the final and very important point which has to do with the all too little appreciated difference between government and the private sector.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

Government is about “protection”. The private sector is about “production.” And the difference is huge. What do I mean?

Most government activities are expenses we make – socially – to provide us with a variety of protections. We pay for the protection of a national defense, police and fire departments, law courts, and, in the past 100 years, for the protection of some kind of old age pension like Social Security or the protection against health-related expenses like Medicare, Medicaid, and now a new healthcare bill just passed. These protections like all protections provide benefits.

Whether the protections are the worth the cost is a huge and important question. And whether they are delivered in the most effective – including most cost-effective – way is another key question. If you have homeowner’s insurance, that protection provides a benefit but whether one policy that costs 2x another policy is worth it, is the same kind of question.

Expenses

Protections are expenses. They can be very important and necessary expenses like, for instance, national defense. But in most cases protections don’t produce wealth. They are expenses that allow us to produce wealth. For example, a police force delivers security which allows us to go about our revenue- and profit-producing business better than we would if there was chaos in the streets every day. But police forces don’t produce wealth.

Producing wealth is about producing profit

Producing wealth is about producing something over and above what it costs to deliver things to people that they want to buy – and that “over and above” is profit. “Profit” is that amount which keeps production going and puts a little away for expanded or new production. The production economy in our free enterprise system is largely the private economy.

Government needs the production machine

The government can only pay for the protections it provides by taking it from the production economy as taxes or by borrowing. But even in borrowing, the only reason the government **can** borrow is because lenders believe the production economy is robust enough that the government could tax it to find the funds to pay interest and repay debt. In that sense the protection machine the government is depends entirely on the production machine of the private economy for taxes and for the potential to tax which lies at the heart of all lenders’ willingness to lend to government.

But the more the government taxes the production economy to pay for the protection it provides the more these taxes lower the profits the production economy can generate and therefore the less the production economy has left over to keep production going and put a little away to expand production or create some new production process.

An inherent tension

At some point the need to fund protection reduces the effectiveness of delivering production. Different people can have vastly different views as to where the cost of protection drags down the output of production. But there is some point where it happens. When it does, the immediate result is slower growth. But longer term the result is a tension which grows and grows between the demands of the protection machine versus the requirements of the production machine.

Protection vs. Production: What Greece Means to Us – Cont'd

March 26, 2010

In Greece the tension has reached the point where it cannot go on, triggered by the fact that the protection machine is being funded by parties outside of Greece. As Herb Stein, Chairman of the Council of Economic Advisors under Presidents Nixon and Ford, has pointed out in his much-cited quip – “[i]f something cannot go on forever, it will stop.”

If you envision the resolution of this tension between the costs of protection and the requirements of production as a storm erupting on the horizon – Greece is up ahead entering in the darkness of the storm. We are further back in the calm. But the seeds of our storm are there. The numbers are telling us. And to the degree we, as investors and businesspeople, would like to understand the macros before they happen and position ourselves to take advantage of them when they happen, one could do worse than pay close attention to what is happening to Greece.

— John Allison

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