Greece and the fiscal crisis in the EMU

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Abstract

The paper analyses the sovereign debt crisis in Greece and other Euro Area countries and the response of the national authorities, the EU institutions (including the ECB) and the IMF. We use economic and political economy perspectives and consider both positive and normative aspects of the crisis and the policy responses.

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1. Introduction

The saga of the Greek public finances continues. But this time, Greece is not the only country that suffers from doubts about the sustainability of its fiscal position. Quite the contrary. The public finances of most countries in the Economic and Monetary Union (EMU) are in a worse state today than at any time since the industrial revolution, except for wartime episodes and their immediate aftermaths. And the problems are not confined even to the Euro Area (EA), but extend to EU member states not in the EA, like the UK and Hungary, and to Japan and the USA. This essay explains how and why this situation came about and how it is likely to evolve during the rest of this decade.

While the origins of this widespread loss of fiscal control are shared by most countries and can be traced to pro-cyclical fiscal policy during the boom period preceding the financial crisis that started in August 2007, the fiscal cost of the financial rescue operations, the revenue losses caused by the recession and the discretionary fiscal measures taken to stimulate economic activity, the uniquely serious situation in Greece owes much to unique features of its economy, its political institutions and its policies. Fiscal sustainability in Greece and elsewhere can only be restored via fiscal pain (tax increases and/or public spending cuts), by inflating away the real burden of the public debt, by economic growth, by sovereign default or by a bailout, and the balance of costs and benefits of these options can vary between different countries.

For countries that are part of the EMU, this balance is complicated by the legal and institutional constraints of EA membership. Nevertheless, we are convinced that any fiscally-challenged EA member is better off within the Euro Area than outside it with an independent national monetary policy. We also believe that the EA as a whole could come out of this crisis stronger than it went in if it uses this opportunity to remedy the design flaw at the heart of it – the absence of a minimal 'fiscal Europe'.

2. The Dimensions of the Fiscal Problem

Figure 1 shows that the fiscal troubles are widespread. In fact, only a small number of industrial countries are in reasonable fiscal-financial shape: Australia, New Zealand, Denmark, Norway, Sweden, Finland and Switzerland. Canada, Germany and the Netherlands, which are widely considered (and consider themselves) to be in reasonably good fiscal-financial condition, are so only compared to the truly dire conditions experienced by most of their peers.

At almost 115% and 14% of GDP, respectively, Greece's (gross) government debt and budget deficit are certainly of great concern. But these numbers are somewhat less staggering when set against a EA average of almost 82% for gross debt and 6% for the budget deficit. And on the whole, the fiscal situation of the EA still appears to be more sustainable than that of the US, the UK or Japan.

Figure 1. Selected Countries – Fiscal Data for 2009

	% of 2009 Nominal GDP				
	Gross Debt	Net Debt	Budget Balance	Structural Balance	Cyclicaly Adjusted Primary Balance
Australia	15.9	-5.7	-3.9	-3.3	-2.5
Canada	82.8	28.6	-3.5	-3.2	-2.3
Czech Republic	42.0	-1.0	-2.8	-4.6	-3.7
Denmark	51.8	-5.1	-1.7	0.1	0.7
Euro area	81.8	51.7	-6.3	-3.6	-1.2
Austria	66.5	37.2	-3.4	-2.4	-0.4
Belgium	96.7	80.7	-6.0	-2.8	0.4
Finland	44.0	-63.2	-2.2	1.1	0.6
France	77.6	50.6	-7.5	-5.7	-3.7
Germany	73.2	48.3	-3.3	-1.4	0.8
Greece	115.1	87.0	-13.6	-11.7	-7.1
Ireland	64.0	27.2	-14.3	-9.9	-8.2
Italy	115.8	101.0	-5.3	-2.7	1.5
Luxembourg	14.5		-0.7	-4.5	-0.2
Netherlands	60.9	28.5	-5.3	-0.8	-3.0
Norway	43.7	-153.4	9.7	-7.4	-3.8
Portugal	76.8	57.9	-9.4	-7.3	-4.7
Slovak Republic	35.7	12.4	-6.8		
Slovenia	35.9		-5.5		
Spain	53.2	34.8	-11.2	-8.3	-7.1
Hungary	84.0	58.0	-3.9	-1.6	2.2
Iceland	122.7	41.0	-9.1	-7.4	-5.0
Japan	189.3	96.5	-5.9	-5.5	-4.5
Korea	34.9	-31.0	0.0		
New Zealand	35.0	-8.1	-3.5	-1.4	-2.3
Poland	58.4	22.3	-7.1	-7.3	-5.3
Sweden	51.8	-23.4	-1.1	2.3	2.6
Switzerland		5.5	0.7	1.3	1.7
United Kingdom	72.3	43.5	-11.3	-8.6	-7.0
United States	83.9	56.4	-11.0	-9.0	-7.6

Sources: Eurostat and OECD

2.1 The Roots of the Fiscal Unsustainability Problems in EMU and Greece

The fiscal unsustainability problems in most advanced economies have four common roots:

First, strongly pro-cyclical behavior by the fiscal authorities during the boom period between the bursting of the tech bubble at the end of 2000 and the onset of the financial crisis of the North Atlantic region in August 2007.

Second, the direct fiscal costs of the financial crisis, that is, the bailouts and other budgetary rescue measures directed at propping up the financial system, starting with the collapse of Northern Rock in September 2007, and expanding massively with the rescue of Fannie and Freddie by the Federal government on September 7, 2008, the Lehman Brothers insolvency on September 15, 2008, and the last-minute rescue by the Federal government and the Fed of AIG and its counterparties in a number of interventions that started on September 16, 2008.

Third, the worldwide recession that started in 2008 and lasted in most of the advanced industrial countries until the end of 2009. The recession weakened many government revenue sources and boosted certain public expenditure categories (like unemployment benefits) for the usual cyclical or automatic fiscal stabilizer reasons.

Fourth, the end of asset booms and bubbles, especially in real estate markets, plus the normalization, from extraordinary heights, of profits and pay in the financial sector, are likely to produce a lasting reduction in the buoyancy of government revenues with respect to GDP in countries with significant construction and financial sectors, resulting in an increase in the structural primary (non-interest) deficit of the sovereign.

Together, these four developments caused an unprecedented peacetime deterioration in the public finances of most of the advanced industrial countries.[1]

In Greece, a number of country-specific factors added to these common causes of the fiscal troubles. In October 2009, following the Greek general election and change of government, Greece's general government budget deficit was revealed

[1] They also caused a sharp deterioration in the public finances of a number of emerging market economies – mainly in Central and Eastern Europe (CEE) and the countries of the Commonwealth of Independent States (CIS, the successor states of the former Soviet Union minus the three Baltic nations, which are part of CEE).

by the new government to be 12.7 percent of GDP rather than the 6.0 percent reported by the old government, and the 3.7 percent promised to the European Commission at the beginning of 2009. The most recent estimate from Eurostat puts the 2009 general government deficit of Greece at 13.6 percent of GDP. And, while the finances of many sovereigns deteriorated strongly as a result of the recent crisis, Greece entered the downturn with a large underlying public deficit already. Greece's budgetary problems owe much to high entitlement and age-related spending, poor tax administration and a bloated public sector. These weaknesses are compounded by the growing uncompetitiveness of much of its industry, as measured for instance by relative normalized unit labor costs, by any other of a range of real exchange rate indices or by Greece's poor showing in such surveys as the World Bank's Doing Business 2010 or the World Economic Forum's Global Competitiveness Report 2009-2010. Spain, Portugal and Italy have similar structural real competitiveness problems.[2]

2.2 Fiscal Unsustainability is not Confined to the Euro Area

It is clear from Figure 1 that the fiscal deterioration is not confined to a few Euro Area member states. The deterioration in the structural (or cyclically-adjusted) fiscal balance of the US and the UK is larger than in Greece, Portugal or Spain. Only Ireland and oil-rich Norway have a larger cyclically-adjusted budget deficit. Rising gross general government debt to annual GDP ratios are likely to take the US and the UK no later than 2011 into the higher-than-90 percent bracket for which Reinhart and Rogoff (2009b) have identified a marked negative effect on the growth rate of real GDP.

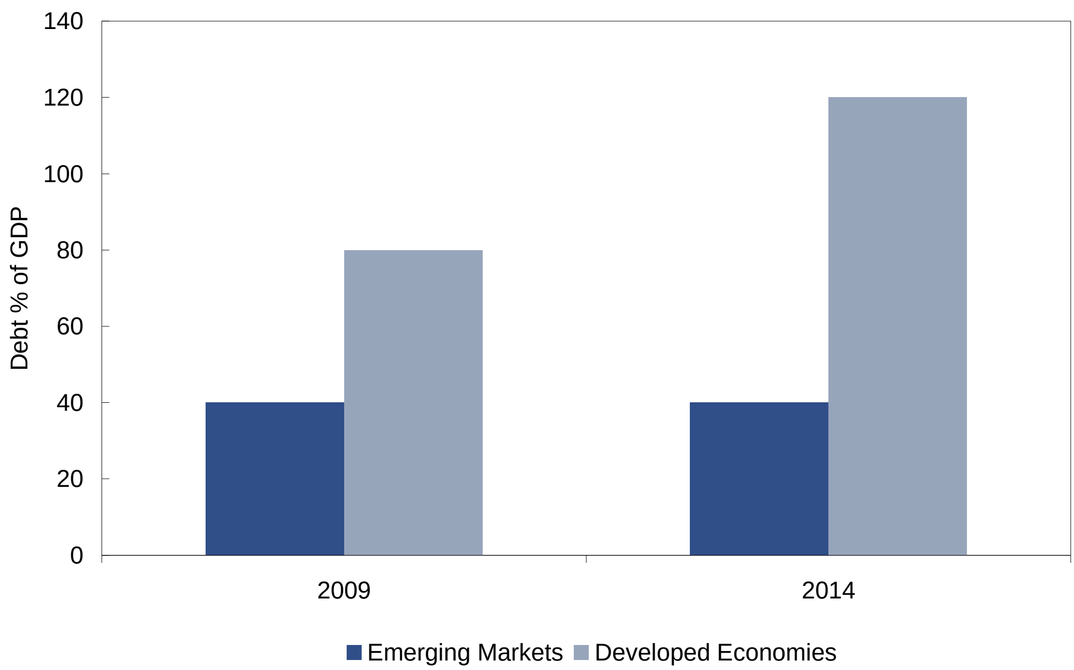
The deterioration in the fiscal positions of most industrialized countries has been spectacular, even more so when set against the remarkable fiscal restraint demonstrated by most emerging markets over the same period. There is only one emerging market amongst the high-government deficit countries in 2009 – India. And India, with a gross general government debt to GDP ratio of over 80 percent during 2009 (see IMF (2010)), is much better able to manage a 10 percent of GDP general government deficit, because during 2009 it had a growth rate of nominal GDP of around 11.5 percent and most of its public debt is denominated in

[2] In the World Bank's Doing Business 2010 ranking of 183 countries by the easy of doing business, Portugal ranked 48th, Spain 62nd, Italy 78th and Greece 109th. The Global Competitiveness Report 2009-2010 ranks 133 countries according to their competitiveness. Spain is ranked 37th, Portugal 43rd, Italy 48th and Greece 75th.

domestic currency and held domestically by a still financially repressed domestic financial system cut off from full access to the global financial markets by capital controls.

It remains true, of course, that India, unlike most other leading emerging markets at the moment, is highly vulnerable to a sudden weakening of nominal GDP growth, which could cause its public debt-GDP ratio to rise sharply unless its underlying government deficit is reduced. But the near total absence of emerging market economies from the list of sovereigns with fiscal troubles and the relatively robust state of public finances in most emerging economies is truly remarkable.

Figure 2. **Public debt (% of GDP) in 20 Emerging Economies and 20 Developed Economies, IMF Projections, 2009 and 2014**

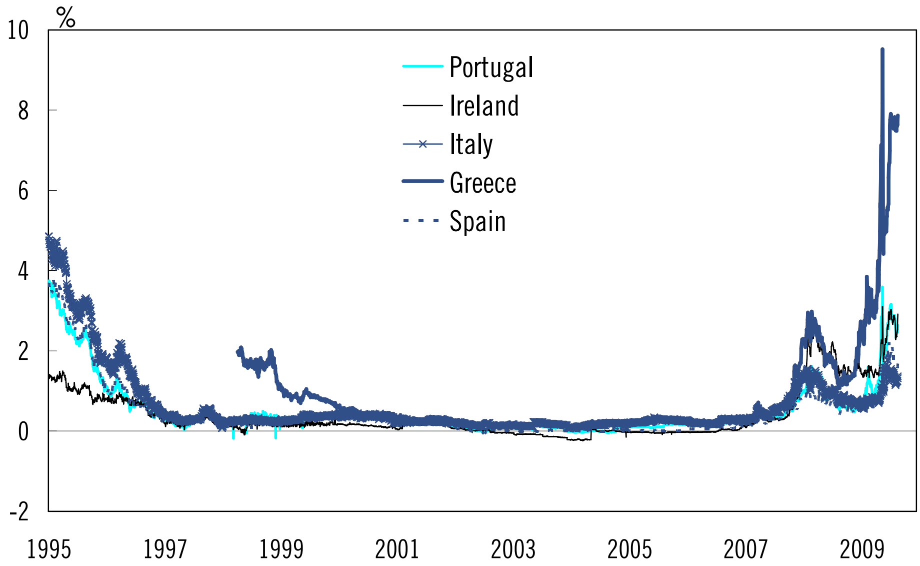


Source: IMF

2.3 Markets wake up after an almost decade long slumber

Prior to the creation of the Euro Area on January 1, 1999, Spain, Portugal, Italy and Ireland all had significant spreads of their 10-year sovereign bond yields over the Bund yield. This reflected market expectations of inflation and exchange rate depreciation for the currencies of these countries – unsustainable fiscal programs were ‘resolved’ by opting for an inflationary solution and associated expectations of currency depreciation vis-à-vis the D-mark. This was then, prior to Euro Area membership, an option because each of the countries had its own independent currency but no independent central bank committed to price stability. Greece did not join the EMU until January 1, 2001.

Figure 3. Selected Euro Area Countries – 10-Year Government Bond Spread vs. Bunds, 1995-Sep 2010



Note: Inflation and exchange rate depreciation driving spreads over Bunds before EMU. A lull from 1999/2001 to 2007. Sovereign default risk driving spreads over Bunds in EMU after 2007.
Source: DataStream

For some reason, perhaps misplaced faith in the ability of the Stability and Growth Pact (SGP) to enable the fiscally-responsible Euro Area member states to discipline the fiscally-irresponsible ones, the markets believed that joining the EMU would deliver a lasting improvement in fiscal sustainability. From 1999 till late 2007 (for Greece from 2001 till late 2007), sovereign spreads over Bunds for the SWEAP countries became very small indeed, often only 20 basis points or less (see Buiter and Sibert (2006)). The onset of the crisis revealed that nothing much had changed as regards the fundamental drivers of fiscal sustainability (or of its absence). So the sovereign spreads opened up again, but this time they reflected not inflation and exchange rate depreciation expectations, but differential perceptions of sovereign default risk.

Spreads over the 10-year German Bund rate of the sovereign 10-year bonds of Greece, Portugal, Spain, Ireland and Italy (all Euro Area members) have fluctuated quite wildly around a steadily rising trend since 2008, as can be seen from Figure 3. Five-year CDS spreads for these five countries tell a similar story. But the strong increase in the spreads at the end of 2009 and in early 2010 indicates that financial markets became extremely nervous at the end of 2009 and early 2010, as concerns about sovereign debt sustainability moved to the fore. Since September 2009, the markets have clearly perceived Greece to be in a sovereign risk class of its own, as reflected in its sovereign default risk spreads in both the CDS and the government bond markets.

2.4 The Political Economy of Restoring Fiscal Sustainability

There are six ways to achieve a reduction in the non-monetary debt burden of the government (by which we mean the augmented general government – the consolidated general government (federal, state and local, including social security etc.) and the central bank):

1. Fiscal pain, that is, an increase in taxes or a cut in public spending. Here it makes sense to recall that public debt problems of the advanced industrial countries are ‘won’t pay’ problems, not ‘can’t play’ problems. More precisely, these countries face the political economy problem of having to agree on, design and implement a fiscal burden sharing agreement – one that commands sufficient political and popular support to be successfully adopted and implemented over a period of years. Fiscal pain is more likely to be chosen as the method for addressing fiscal unsustainability the less polarized are the electorate and the polity in general. Even if a national consensus on fiscal burden sharing can be established, government institutions and political incumbents capable of swift and decisive action are also required.

2. Increased recourse to seigniorage or revenues from monetary issuance by the central bank. In addition to the revenues from base money issuance (whose real value is likely to first rise and then decline with the *expected* rate of inflation), there is the reduction in the real value of long-dated fixed-interest rate nominal debt, which is higher the greater the *unexpected* increase in the inflation rate. The incentive to use unanticipated inflation boosts to reduce the real value of servicing the public debt will be stronger the larger the share of the debt that is held externally (foreigners don’t vote) and the longer the maturity or duration of the outstanding debt. The opportunity to have recourse to seigniorage would depend on the extent to which the central bank is

independent and committed to price stability. The fact that the European Central Bank is deemed to be the central bank with the highest degree of independence and the strongest commitment to price stability would seem to weigh against this option in the EA. But if a sufficient number of national Treasuries are in favor of this option, we are likely to see a “Game of Chicken” between the ECB and the Treasuries, with the Treasuries ultimately prevailing.

3. A lower interest rate on the public debt. Unfortunately, this is not a policy instrument of the sovereigns though it is of course affected by policy actions and the reality and expectation of external financial support.

4. A higher growth rate of GDP. Again, the growth rate of GDP is not a policy instrument. Moreover, growth in the Euro Area is likely to be weak in the near future, even if growth turns out to be somewhat higher that the very pessimistic expectations held at the beginning of 2010 implied. In addition, history, including very recent history, has shown that higher growth often raises the pressure for higher spending, thus partly negating the benign effect of higher growth on revenues.

5. Default, which here includes every form of non-compliance with the original terms of the debt contract, including repudiation, standstill, moratorium, restructuring, rescheduling of interest or principal repayment etc.

6. A bailout (which can be interpreted either as a current transfer payment from abroad or a capital transfer from abroad).

3. EU/IMF/ECB Support Measures

In early May 2010, 10-year yields on Greek government debt topped 10 percent, while the spread on 5-year credit default swaps exceeded 900 basis points, and there was substantial doubt – to say the least – about the willingness of markets to finance Greece’s remaining sovereign funding needs of around €30bn for the current fiscal year even at these very high rates. At the same time, spreads versus Bunds on debt of the governments of Spain, Portugal and Ireland also reached levels not seen since the mid-1990s amid concerns about the health of the public and financial balance sheets in these countries. In response, three sets of measures were announced. First, the EU and the IMF announced a €110bn support package for Greece. This support package then received a bigger sister for the rest of the EA member states by the name of the European Stabilisation Mechanism (ESM). This consists of the European Financial Stability Facility (EFSF), which can raise up to €440bn of intergovernmental EA money, and a further €60 supranational facility administered by the European Commission.[3] Up to €250bn of IMF money will be available to supplement the ESM. Third, the ECB lent its own support to prevent major market disruptions, to rule out sovereign defaults it did not consider warranted by the fundamentals and to prevent another banking crisis in the EA, where many banks had unknown but potentially significant exposures to the fiscally-challenged sovereigns. Until the EFSF became operational on August 4, 2010, the €60bn supranational fund and the ECB/Eurosystem were all that stood between the EA member states and a potentially devastating sovereign debt crisis and banking crisis.

3.1 The Greek support package

Details about the joint EA/IMF support program for Greece were presented on May 9. The EA/IMF agreed to provide €110bn in what are initially three-year loans, with €80bn provided by the EA member countries according to their respective paid-up capital shares in the ECB, with the remainder made up by the IMF. The loans would be disbursed in tranches and the program would imply that Greece would not need to have to access markets again until 2012. Rates for variable rate loans will be 3-month Euribor plus 300 basis points (bps) for maturities up to 3 years (400bps for longer maturities). For fixed rate loans, 3-month Euribor is replaced with the swap rate for the loan's maturity and both fixed and variable rate loans also incur a one-off 50bps charge for operating expenses. In addition, Greece agreed to subject itself to tough conditionality, negotiated and applied by the IMF. In exchange for external aid, Greece agreed to implement a fiscal adjustment worth €30bn (or 12.5% of 2009 GDP) spread over the next three years. This tightening comes on top of the measures already announced (and partly implemented) so far this year, which amounted to around 6% of GDP. The deficit is targeted to decline to 3% of GDP by 2014, postponing by two years the deadline previously agreed with the EU Commission.

[3] The € 60bn supranational facility, which is supposed to be based on Article 122.2 of the Treaty is in principle available to all EU members, not just the EA members.

The bulk of the measures will focus on the same areas as previous austerity packages, imposing higher indirect taxes hikes (the VAT rate to move up again from 21% to 23%, and fuel and alcohol taxes to increase by 10pp) and further public sector wage, pension and employment cuts. More importantly, a change in the state pension system will also be introduced to raise the minimum retirement age to 60 years. Reform of the labor market, privatization of a number of state enterprises and tax administration reform are also part of the program. Finally, a €10bn contingent fund will be set up as part of the package to support the Greece banking sector over the next three years.

3.2 The European Stabilisation Mechanism

Over the weekend of Friday, 7 May, to Sunday, 9 May, Ecofin, the Council of the finance ministers of the 27 European Union member states, together with the European Central Bank and the European Commission, cobbled together a financial rescue package for the Euro Area member states.[4] The support measures are made up of three parts, a supranational €60bn European Union (EU) fund administered by the European Commission (EC), a €440bn intergovernmental facility, the EFSF (a special purpose vehicle incorporated in Luxembourg), and €250bn from the IMF. We shall refer to them jointly as the European Stabilisation Mechanism (ESM), even though that term strictly refers only to the two EU components.

The contribution of each EA country to this facility is supposed to be according to its share of the paid-up capital of the ECB. In addition, each member state is supposed to guarantee 120% of its contribution. In order to access the EFSF, member states need to request a loan and agree on a memorandum of understanding (MoU) with the European Commission. This MoU will include the conditions attached which are presumably along the lines of those included in the Greek support package. While the loan terms are only finalized at the time of disbursement, they will presumably also be very similar to those agreed on for the Greek facility.

3.3 ECB Support Measures

[4] The 27-member Ecofin consists of the Eurogroup (the finance ministers of the 16 member states of the Euro Area) and the 11 finance ministers of European Union member states outside the Euro Area.

With only the €60bn supranational facility actually approved on May 10, and with even that small facility not yet operational, there remained a risk that contagion from the Greek sovereign would have created a liquidity and funding crisis for other EA sovereigns, notably Portugal, Spain and Ireland, but possibly even Italy or others. Following the weekend of 7 May to 9 May, only the ECB had the means to intervene and safeguard the EA sovereigns at risk from a contagion-driven sudden stop and sovereign default.

The ECB chose to act and announced a number of policy changes, the most important and remarkable of which was its commitment to purchase government securities outright in the secondary markets, an unprecedented departure both from its past practice and from its prior view of how an independent central bank ought to behave. Under its newly-created "Securities Markets Programme", the ECB can purchase any private and public securities outright in secondary markets. The ECB then went to great lengths to explain that this did not amount to quantitative easing (QE), as it would sterilize these purchases by collecting term deposits. As 'sterilization' means replacing overnight deposits with the central bank with one-week term deposits (which constituted eligible collateral for borrowing from the Eurosystem), the distinction between QE and asset purchases under the Securities Markets Programme is semantic, not substantive. It also stressed that it acted on the basis of its financial stability mandate, addressing dysfunctional markets, and not out of a concern for sovereign liquidity or even solvency.

3.4 The Modalities of a Bailout in the Euro Area/ EU

3.4.1 Is a Bailout Legally Possible in the EU/Euro Area?

One often hears statements, especially from opponents of bailouts of EU member states by other EU-member states, that the 'no-bailout clause of the Treaty' (currently the Lisbon Treaty) forbids a bailout of a member state government by other member state governments, the European Commission (EC) or the European Central Bank (ECB). In fact, there is nothing like a blanket no-bailout clause that prevents the bailout of an EU or EU sovereign by another sovereign or by any EU institution, including the ECB. What Article 125.1 of the Treaty forbids, subject to a key qualification, both the EC (the Union) and member states from engaging in, is *to assume the commitments* of the public sector of another member state, or *to be liable for them*. In plain English, this prevents the EC and member states from guaranteeing the public debt of other member states. It does not even prevent the EC or member states bilaterally or jointly making loans to or giving grants to another member state. It does not prevent the EC and member states from purchasing outright the debt of another member state sovereign. It does not prevent member states from guaranteeing bank loans provided by private banks or state-owned/state-controlled banks to a member state sovereign. Only guarantees of foreign public debt are not permitted, and even (mutual financial) guarantees are permitted as long as they are *"for the joint execution of a specific project"*.

What is a project? It is not defined in the Treaty. Anything can be a project. To a wife, a husband is a project. Article 125.2 grants the Council the power to define a project to be anything it wants it to be.

3.4.2 Bailout by other EU Member states or by the EC

According to the ESM Framework Agreement, the ESM was created under Article 122.2 of the Treaty which says *"Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned…."*

Obviously, Greece's fiscal predicament is not due to a natural disaster or some other external event beyond its control, but to an internal man-made disaster. The same would presumably apply to other applicants to the facilities though the member states may well argue that being cut off from financial markets – due to irresponsible policies or not – is an event that is beyond their control. Arguably, even solvent and prudent states can become the victims of contagion and this would be beyond their control. The fact that the only EA member states that have been tested by the markets have been those whose public finances are clearly unsustainable rather weakens the case for application of Article 122.2 on the grounds that Portugal, Spain, Ireland etc. are the hapless victims of blind contagion. A justification of the Council decision to provide Union financial assistance based on this article truly is a bit of a stretch.

3.4.3 Bailouts by the ECB

Article 123 (ex Article 101 TEC) of the Treaty forbids the ECB (or the Eurosystem) from giving credit to or purchasing sovereign debt from sovereigns. However, it does not say anything about purchasing sovereign debt on secondary markets, a distinction the ECB was adamant to highlight though, in our view, these actions, while certainly appropriate, conform more with the letter than the spirit of the Treaty.

3.4.4 Bailouts by the IMF

It is sometimes argued that the IMF cannot lend to Greece because, according to Article V of its Articles of Agreement, it can only lend to countries with balance-of-payments difficulties and Greece or any other individual member of the EA no longer has a balance of payments – only the EA as a whole does.

Since the beginning of EMU (or since 2001, the year of EA entry for Greece), the EA member countries no longer have a "balance of payments" in the sense of 'monetary balance', 'international reserve balance' or 'official settlements balance' – measuring the net increase in gold and official foreign exchange reserves (typically held by the central bank). Indeed, only the 16-nation Euro Area as a whole has a balance of payments in this narrow sense.

However, it is clear that IMF itself does not use the term balance of payments in this narrow way, but instead uses it to refer to the balance of a nation's external transactions more broadly. Clearly, Greece has a balance-of-payments problem. Its low private and public sector saving rates have resulted in persistent external current account deficits, which have cumulated into a large negative net external investment position (since 2000 it almost doubled from -38.8% to -69.8% in 2008). The IMF, with its long history of providing external resources to over-extended governments and nations on a short-term basis and against strict macroeconomic, financial and budgetary conditionality, is ideally set up to address precisely these kinds of difficult conditions. Its prior absence in dealings with EA member countries can mainly be traced to earlier vehement opposition by the ECB, the President of the Eurogroup (Jean-Claude Juncker) and many other Euro Area representatives (notably the French government) for reasons of pride and prestige.

3.4.5 Does the German Constitution Allow a Bailout of Greece?

Two court cases remain before the German Federal Constitutional Court in Karlsruhe. The first action concerns the law governing Germany’s contribution to the Greek facility and argues that Germany’s participation would violate Germany’s Basic Law (Constitution), specifically that it would violate the constitutional right to property (Article 14 of the Basic Law) and other fundamental principles of the Constitution, such as the principle of democracy and the social state (Articles 20, 23 and 28 of the Basic Law). The second action before the Constitutional Court, brought by a member of the Bundestag, is based on the argument that the laws governing Germany’s contribution to the Greek facility and to the EFSF are in breach of Article 125 of the Treaty on the Functioning of the European Union (TFEU). This is the Article that contains what is often referred to as the ‘no bailout clause’. The claimant argues that the Act has to be considered as an amendment of the European Treaties and could only enter into force if the necessary procedure for such amendments at the European level had been respected. Therefore, the claimant contends, the Bundestag did not have the competence to approve the guarantees.

We shall not try to argue the legal merits of this interpretation, beyond pointing out that Article 125 strictly only precludes member states from guaranteeing the debt of governments of other member states, and even that preclusion is waived provided this takes the form of mutual financial guarantees for the joint execution of a specific project, to be defined by the Council. The decision of the Court, like that of Supreme Courts in other countries, will likely be driven by political concerns and considerations, rather than textual exegesis.

4 The Road Ahead for Greece and EMU

4.1 Greece’s debt burden is unsustainable, with or without the support package

By early May, Greece had already received €20bn (€14.5bn from the EU, €5.5bn from the IMF). On August 5, the EU/IMF announced that the second tranche of €9bn would be released as Greece had hit the milestones specified in the initial agreement. So will the Greek consolidation effort succeed in bringing down the public debt burden and restoring fiscal sustainability? A reading of the literature on successful fiscal consolidations, such as in Canada (1994-98), Sweden (1993-98), and New Zealand (1990-94) or more broadly, suggests some caution. First, the initial debt and deficit positions were not as unfavorable in these countries. Furthermore, studies such as Ardagna (2004), Alesina and Ardagna (2002), and European Commission (2007) find that past economic growth, a lower level of the initial deficit to GDP and a higher level of the initial debt to GDP ratio increase the chances that consolidation will succeed. Only the second of these favors Greece.

Other lessons from these studies are that for improvements in the public finances to be lasting, significant public sector reforms and other structural reforms including deregulation, privatization, labor market reforms and product market reforms are required. These tend to reduce the scope and scale of the state's involvement in the economy, through public sector employment, pay and pension cuts and through changes in ownership, accountability mechanisms and incentives. They also increase the flexibility of the wider economy and raise the level and possibly the growth rate of potential output. Nowhere in Europe would such changes be more appropriate than in Greece.

Similarly, fiscal consolidations achieved mainly through reductions in public spending, and specifically through reductions in current public spending (mainly public sector pay and employment and entitlement spending), tend to be sustained more effectively than consolidations achieved principally through tax increases.

The IMF catalogue of conditionality contains a number of measures that fall into the right buckets from the perspective of these studies. And so far Greece appears to show some resolve in following through on its commitments. But even if all the promised fiscal tightening is implemented, and if the Greek economy does not contract more severely than expected, the general government gross debt will reach 145-150 percent of GDP by 2013. To talk of it being stabilized at that level is disingenuous. The government interest bill on that debt would be around 8 percent of GDP, but the primary balance would be in surplus. A high level of debt (with a correspondingly high interest burden) with small or negative primary deficits are exactly the circumstances under which it would be individually rational for a sovereign creditor to default. Since external or third-party enforcement of contracts involving the sovereign is unlikely, the only real penalty for default is the temporary exclusion of a defaulting sovereign from the international and possibly also the domestic capital markets. Since the collective memory of markets is rather short and primary budgets will by then be in balance, the present value of access to international capital markets will most likely be less than the burden of interest and principal payments on the outstanding government debt.

The political economy of fiscal tightening is already quite complex and fraught in Greece and the current fragile consensus for fiscal consolidation is highly unlikely to survive until 2013 and beyond. These facts and the logic of strategic default will not be lost on the markets. We therefore expect, with a high degree of confidence, that a restructuring of Greek public debt, involving both maturity lengthening and NPV haircuts for creditors will have to take place relatively soon – certainly before the expiry of the three year lifespan of the Greek facility, in May 2013. Such restructuring would ideally have taken place in May 2010, as a precondition for Greek access to EU and IMF funds. Instead, a restructuring, if and when it occurs, will be against the IMF/EU agreement and would impose capital losses on Greece's EA creditors, because the loans from the Greek facility (and from the EFSF) are *pari passu* with the outstanding Greek debt (the IMF claims preferred creditor status).

In a recent IMF study (Cottarelli et. al. (2010)) it is argued that sovereign default in today's advanced economies is unnecessary, undesirable and unlikely. Certainly for the most highly indebted Euro Area sovereigns (such as Greece, Italy and even Ireland (if we add to the conventional gross general government debt the exposure of the sovereign to toxic bank assets through the NAMA (the state-owned bad bank) and through its guarantee of most of the remaining bank debt), the undesirability of a sovereign default is not obvious. Any breach of contract damages the rule of law, but there are circumstances where default may be the lesser evil.

The results of both private (debtor) and social cost-benefit analyses of sovereign default depend on what the alternatives are: which taxes will be raised and which spending programmes will be cut. Sovereign default redistributes resources from the creditors (the bond holders) to the tax payers and the beneficiaries of public spending that would be cut in the absence of a default. These competing claims carry different weight in different times and circumstances. With Greece likely to have a general government gross debt not much below 150% of annual GDP by mid-2013 (if the debt is not restructured before that time), an annual interest bill of between six and seven percent of GDP would represent a significant fiscal burden. The cost to the sovereign of exclusion from the international and possibly even the local capital markets following default depends on the current and prospective future path of the government's primary surplus and the duration of the exclusion.

Most examples of countries discussed in Cottarelli et. al. (2010) that worked off high public debt burdens without sovereign default involved countries that either used the unanticipated inflation tax, and/or achieved a significant real exchange rate depreciation through a nominal exchange rate depreciation and the fortunate combination of real wage flexibility and nominal wage rigidity. High real GDP growth was always part of the process. Greece does not have independent national monetary policy and nominal exchange rate flexibility. Even if it did, the fact that Greece is more likely to have real wage rigidity and money wage flexibility than the Keynesian configuration, makes these the Cottarelli et. al. examples of limited relevance to Greece. Sustained high real growth in Greece would, as we argued earlier, require an economic and political transformation that appears highly unlikely under current circumstances. The blanket statement that sovereign default in today's advanced economies is unnecessary, undesirable and unlikely would appear to be based on bad economics and simplistic political economy.

4.2 The Role of the Banking Sector

Why was a restructuring not already part of the original IMF/EU agreement for Greece? The answer is that a Greek sovereign default would not be costless to the rest of the EA. The reason is that most of the exposure to the Greek sovereign and to other Greek borrowers (e.g. the Greek banks) is with the banks from other EA member states (see below). The choice faced by the French and German authorities in particular is to either bail out Greece or to bail out their own banks.

Politically, neither financial rescue action would be popular. Which one would be cheaper financially?

European banks, especially Euro Area banks, are seriously exposed to Greek risk, as is clear from Figure 4, which reproduces some of the BIS data on the consolidated foreign claims of reporting banks — ultimate risk basis. For the 24 reporting countries, the total exposure of their banks to Greece at the end of September 2009 was US$298.3bn. European banks accounted for almost all of this, US$272.4bn.

Figure 4. Claims of European Banks on Greece, USD bn, March 2010

	Q4 2009	%	Q1 2010	%
European Banks	193.1		182.6	
France	78.8	40.8	71.1	39.0
Switzerland	3.7	1.9	4.2	2.3
Germany	45.0	23.3	44.2	24.2
United Kingdom	15.4	8.0	11.8	6.4
Netherlands	12.2	6.3	11.3	6.2
Portugal	9.8	5.1	11.7	6.4
Ireland	8.6	4.5	8.0	4.4
Italy	6.9	3.6	6.8	3.7
Belgium	3.8	2.0	3.7	2.0
Austria	4.8	2.5	5.2	2.8
Spain	1.2	0.6	1.1	0.6
Sweden	0.7	0.4	1.0	0.5
Turkey	0.3	0.2	0.5	0.3

Note: European banks refer to domestically-owned banks of European countries that report claims on an ultimate risk basis (i.e. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom). Source: BIS (2010), http://www.bis.org/statistics/consstats.htm, Table 9D

We believe it is plausible that a bailout of Greece with tough conditionality would be cheaper for the EA member states than a bailout of their own banks, should Greece default unilaterally. The reason is that a tough bailout would discourage recidivism by Greece as well as emulation of its fiscal irresponsibility by other would-be applicants for financial support (e.g. Spain, Portugal, Italy, Ireland etc.). However, a soft bailout of Greece would be more expensive than a bailout of the domestic banks of the other EA members, because it would lead to open-ended and uncapped demand for financial support from all and sundry.

The threat of letting Greece fail and instead bailing out the banks of France, Germany and other Euro Area countries whose banks are exposed to the Greek sovereign and to Greek private sector risk may in the spring of 2010 have had rather limited credibility because of the extreme concentration of this exposure in the Euro Area banks. As the exposure to the Greek sovereign, and to Greece generally, is moved off the balance sheets of the Euro Area banks and dispersed more thinly over a wide range of private sector portfolios (or taken under the wings of the state, by transferring it to state-owned or state-controlled banks like KfW or CDC, or directly to a government-owned 'bad bank' or to the Treasury balance sheet), the systemic damage that could be caused by a Greek sovereign default would diminish. The threat: 'we don't have to bail Greece out, we can live with the financial consequences of a sovereign default in Greece', should become more credible as time passes.

The most immediate threat to the Greek sovereign is, in our view, likely to come through its banking system. Greece has no independent national central bank which can, in the final analysis, be compelled by the government to act the way the government wants it to act. The Greek commercial banks now obtain most of their short-term funding from the ECB/Eurosystem, using mainly Greek sovereign debt as collateral. When the value of the Greek sovereign debt declines in the secondary market, the mark-to-market value of the collateral offered by the Greek banks to the ECB/Eurosystem declines and triggers margin calls (demands for additional collateral to make up for the reduced value of the existing collateral). Their funding needs are likely to be exacerbated by a withdrawal of deposits that could become a run – both from deposits over the limit of the deposit insurance scheme and from deposits below that limit, if the solvency of the national deposit insurance scheme is in doubt.

Similarly, while the EFSF is technically only supposed to be a sovereign liquidity facility and banks cannot directly access it, much of the concerns about fiscal sustainability of EA countries that led to its creation are driven by contingent liabilities that the sovereigns would take on if some of their financial institutions fail.

The sovereign debt problems encountered by most advanced industrial countries are thus the logical final chapter of a classic 'pass the baby' (aka 'hot potato') game of excessive sectoral debt or leverage. First, excessively-indebted households passed part of their debt back to their creditors – the banks. Then the banks, excessively leveraged and at risk of default, passed part of their debt to the sovereign. Finally, the now overly-indebted sovereign is passing the debt back to the households, through higher taxes, lower public spending, the risk of default, or the threat of monetization and inflation.

4.3 Should Greece leave the Euro Area?

Is a fiscally-challenged country likely to want to leave the Euro Area? The brief answer is no – quite the contrary: a fiscally weak country is better off in the Euro Area than outside it.

The only argument for leaving the Euro Area is that the introduction of a new national currency (New Drachma, say) would lead to an immediate sharp nominal and real depreciation of the new currency and a gain in competitiveness, which would be most welcome. It also would not last. The key rigidities in small open economies like Greece are real rigidities, not persistent Keynesian nominal rigidities, which are necessary for a depreciation or devaluation of the nominal exchange rate to have a material and durable impact on real competitiveness. Unless the balance of economic and political power is changed fundamentally, a depreciation of the nominal exchange rate would soon lead to adjustments of domestic costs and prices that would restore the old uncompetitive real equilibrium.

All other arguments either favor staying in for a fiscally weak country or are neutral.

- As regards the existing stock of sovereign debt, in or out makes no difference. Re-denominating the old euro-denominated debt in New Drachma would be an act of default. A country might as well stay in the Euro Area and default on the euro-denominated debt.

- As regards new government borrowing, issuing New Drachma-denominated debt would be more costly (because an exchange risk premium would be added to the sovereign risk premium) than new borrowing using euro-denominated debt as part of the Euro Area.

- There would be massive balance sheet disruption for banks, other financial institutions and other corporates with large balance sheets, as the existing stock of assets and liabilities would remain euro denominated but there would no longer be a euro lender of last resort. It may be possible for contract and securities internal to Greece, that is entered into or issued under Greek jurisdiction alone, to be redenominated in New Drachma, but cross-border contracts and securities issued in other jurisdictions could not be redenominated that way without this constituting an act of default.

- There would be no fiscal-financial support from other Euro Area member states should a country leave the Euro Area.

- Leaving the Euro Area means leaving the EU. There is no such thing as a former Euro Area member that continues as an EU member. A current EA member wishing to leave the EA but continue as an EU member would have to leave both the Euro Area and the EU and then re-apply for EU membership. Under the Lisbon Treaty, there now is a procedure for leaving the EU (see Athanassiou (2009)).

- A country cannot be expelled from the Euro Area, or from the EU (see Athanassiou (2009)).

The only real threat of the Euro Area breaking up comes from the possibility that one or more of the fiscally strongest and more competitive members (Germany) could decide to leave the Euro Area (and the EU), because of a fear of becoming the bailer-out of first resort for all would-be fiscally-insolvent Euro Area member states. The changing of the generations in Germany from Kohl to Schröder and then to Merkel has weakened the traditional umbilical link of Germany, and especially Germany's political class, to the EU and the Euro Area, but not (yet) to the point that one can reasonably envisage Germany leaving the Euro Area and the EU. Given half a decade of funding and subsidizing other EA countries with unsustainable fiscal positions and no capacity or willingness to correct these, that could change.

4.5 Prospects for EMU: Institutional Reform to Survive and Prosper

The EFSF constitutes an important step towards the creation of a “minimal fiscal Europe” necessary for the survival and prosperity of the EMU for both political and economic reasons.

To the nations sharing a common currency in a formally symmetric monetary union (rather than by unilateral adoption of another nation’s currency), national sovereign default becomes an issue of common concern, beyond what would be called for by purely individually rational national concerns about contagion and other spillovers. This does not mean that national sovereign risk is fully pooled in a monetary union. The debt of the sovereign of an individual member state can still be restructured, be subject to a haircut or be defaulted on unilaterally. Subsidies from solvent sovereigns to sovereigns of doubtful fiscal probity are not necessarily called for.

Unilateral sovereign default by one or more Euro Area member state government would from a technical economic and financial perspective be consistent with the survival of the Euro Area. The defaulting sovereign would have no economic incentive to leave, and the countries that would otherwise have been called upon to provide financial support to prevent the sovereign default will also be happy to stay in, even if they would have been inclined to leave should the financial support for the fiscally weak member state have turned into an open-ended and uncapped stream of subsidies. It is, however, likely that political support for continued membership in the Euro Area (and the EU) would decline both among the political elites of the defaulting country and among its citizens.

From an economic perspective too, it is clear that a minimal fiscal Europe is necessary to make up for the loss of independent monetary policy as a sovereign default prevention mechanism. The loss of macroeconomic stabilization potential associated with giving up independent national monetary policy (including its alleged ability of nations to use national monetary policy to manage the real effective exchange rate in a desirable manner) is, in our view, negligible and may well turn out to represent a net gain rather than a loss. This is because, in a world with a high degree of financial capital mobility and a floating exchange rate, the exchange rate is more likely to be a source of extraneous noise, excess volatility and persistent misalignment of real exchange rates than an effective buffer against internal or external shocks. But giving up any scope for the discretionary use of both the anticipated and the unanticipated inflation taxes to reduce the real value of domestic-currency-denominated monetary and non-monetary public debt should be compensated for by some form of mutual fiscal or liquidity insurance.

In addition to the creation of the EFSF, some further actions are required to create an effective 'minimal fiscal Europe'.

First, the EFSF should be made permanent. The risk of one or more EA nations straying from the path of fiscal probity will always be with us. So should the institutions and policy instruments to deal with that contingency.

Second, the size of the EFSF should be increased. For it to be an effective deterrent, it has to satisfy Colin Powell's dictum that if you go in at all, you go in with overwhelming force. We believe that a 'big bazooka' version of the ESM would require that it be able, once it has been fully pre-funded (as it ought to be), to finance all Euro Area sovereigns for 2 years. That means at least €2 trillion.

Third, the conditionality attached to the loans has to be tough and credible, and must be enforced rigorously. Any nation requesting use of the facility has to be willing to accept the full array of fiscal-financial and structural reform conditionality.

Fourth, the loan facilities must be supplemented with a Sovereign Debt Restructuring Mechanism (SDRM) to achieve an orderly restructuring of the debt of sovereigns for whom default is unavoidable. The SDRM could be invoked 'ex-ante', that is, there could be an upfront sovereign debt restructuring involving both maturity lengthening and NPV haircuts for the creditors, should the EC, the ECB and the IMF determine that there either is a sovereign insolvency problem or that the odds on a successful program are much better following a restructuring of the public debt. The SDRM should also be invoked 'ex-post', in the case of willful non-compliance with the conditionality by a borrowing country. This is because the ultimate sanctions against nations willfully failing to comply with the conditionality are the refusal to extend new loans and the calling of outstanding loans, as well as the loss of eligibility for the non-compliant nation's sovereign debt as collateral with the Eurosystem. This would in all likelihood push the non-compliant borrower into default. This default should be handled in an orderly manner through the SDRM.

Other possible sanctions for non-compliance with conditionality include the forfeit of Structural and Cohesion Funds, the suspension of voting rights in the Eurogroup (the finance ministers of the EA) and in Ecofin, and suspension of voting rights in ECB Governing Council. Loss of voting rights would require Treaty amendments.

Fifth, a well-functioning monetary union requires a fund to recapitalize systemically important cross-border financial institutions, either to permit them to continue operating or to allow them to be wound up or liquidated without unnecessary social costs. Let's call this the Financial Institution Recapitalisation Fund (FIRF). The funding of the FIRF (which could also be created using the Enhanced Cooperation procedures in the Lisbon Treaty) could come from the national Treasuries of the EA or the EU, from the systemically important financial institutions that would benefit from it, or from some combination of these two sources. The EFSF and the FIRF could be separate institutions or they could be merged.

Finally, note that the minimal fiscal Europe does not require independent tax and borrowing powers for a supranational European Fiscal Authority (EFA).

5 Conclusion

The current fiscal problems faced by Greece and other EA countries are of a severity unprecedented in peace time. The resolution of this situation will most likely involve a combination of fiscal pain and debt restructuring, with the latter all but inevitable in the case of Greece.

Nevertheless, the Euro Area and the EU could come out of this crisis stronger than it went in. A first step has already been taken with the creation of the EFSF. Further steps to create a viable minimal 'fiscal Europe' are needed, including a burden-sharing arrangement for the recapitalization or orderly liquidation of systemically important cross-border financial institutions, an increase in the size and duration (to eternity) of the EFSF, credible conditionality attached to the loans it disburses, and the creation of an SDRM for EA member state governments.

Any rational would-be sovereign defaulter would stay in the Euro Area. The near-term risks to the Euro Area, though very small, come from possible outbursts of irrationality and misunderstandings of each others' intentions by the protagonists in the sovereign debt debate. A clear example would be the removal of the Greek PM and finance minister (Papandreou and Papaconstantinou) from their positions and their replacement by isolationists, populists or conspiracy theorists. The new leadership could, in a fit of collective blindness, decide to leave the Euro Area and the EU. We consider this highly unlikely, but not impossible. The risk of Germany and other fiscally strong countries deciding to leave the Euro Area and the EU (and to recreate it under a different name without the fiscally weak current EA member states) is both farther into the future (say 5 to 10 years) and very small, because we don't consider a soft bailout to be a likely outcome of the current bailout game.

Although we believe that the 'too big to save' problem has been overstated as regards Spain and even Italy, a collective, simultaneous fiscal crisis affecting all five peripheral EA countries could stretch the political fabric of cross-border fiscal-financial solidarity to breaking point. The financial and economic resources to prevent a default are clearly there – the average fiscal position of the Euro Area is significantly stronger than that of the US and the UK, and we consider neither the US nor the UK to be likely candidates for sovereign default. The politics of cross-border mutual fiscal insurance and support are, however, complex and may not fall in place at the pace required by an unfolding financial crisis.

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