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The "Greek" Crisis: Origins

At an extraordinary meeting of the European Council on the weekend of May 9 and 10, 2010 the heads of state and government of the European Union (EU) agreed to allocate €500 billion in special assistance to help member states that no longer have access to market-based financing to meet their balance of payments and fiscal obligations. They also negotiated with the International Monetary Fund (IMF) to "provide at least half as much as the EU contribution through its usual facilities" – bringing the total volume of financial assistance to €750 billion.[1] At interbank exchange rates on the first market day after the policy was announced, May 11, this support was worth just over $968 billion. This support was $200 billion more than the Troubled Asset Relief Program (TARP) funds requested by the outgoing George W. Bush Administration and authorized by Congress in 2008 during the market turmoil that followed the failure of the Lehman Brothers investment bank.[2] Meanwhile, the Governing Council of the European Central Bank (ECB) decided over the same weekend to intervene directly in "dysfunctional" public and private debt security markets in order to ensure that they remain both liquid and deep, buying up distressed bonds and holding them on its own balance sheet.[3] This may sound reassuringly technical to anyone unfamiliar with the arcana of central banking, but for those who follow European central banking practices, it was as though the world turned upside down.

The purpose of this briefing is to explain how the EU got into such a dire situation – one which many have described as the most important challenge yet to the stability of the single European currency. A companion briefing will look at how things are likely to develop from here. This briefing has five sections. The first looks at the proximate problem of Greek indebtedness. The second explains how this problem extends well beyond Greece. The third sketches Europe's halting attempts to address this situation before it evolved into a crisis. The fourth suggests why those efforts were not more successful. The fifth concludes with a short narrative of Europe's last ditch effort to stabilize the Greek situation and brings us back to the unprecedented announcements of May 10 and 11. These conclusions explain why it will be difficult to create a lasting solution to the "Greek" crisis, and thus introduce the next brief.

Greek Public Finances

For much of the world, the current European crisis traces back to the Greek national parliamentary elections held on October 4, 2010. These elections were called early (the previous elections were held only in 2007), primarily due to a combination of social unrest and corruption scandals, and they were fought primarily along economic lines.[4]

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The incumbent New Democracy (ND) party sought a mandate for austerity. Although the government reported only a relatively modest fiscal deficit – estimated at 3.7% of gross domestic product (GDP) for 2009 – the party leadership was well aware of the need to re-balance government finances in light of the global economic downturn. The opposition Pan-Hellenic Socialist (Pasok) party took the opposite view and campaigned on a platform of fiscal stimulus to restart the economy. Given these alternatives, the voters opted for a Keynesian reflation; ND's vote share fell by more than 8.3 percentage points, Pasok's increased by 5.8 percentage points, and Pasok leader George Papandreou was allowed to form the government with control over 160 out of 300 seats.[5]

Once in power, Papandreou necessarily changed course on his economic proposals. Although he remained committed to some kind of reflation to mitigate the downturn, he revealed that the prospects for a Keynesian style fiscal stimulus were limited by the unexpected magnitude of the country's fiscal deficit. On October 21, his government sent revised data to the EU's statistical reporting agency, Eurostat, indicating that the deficit for 2008 would come in at 7.7% of GDP rather than the 5.0% reported the previous April by his predecessor, and revising the 2009 estimate from 3.7% of GDP to 12.5%. Moreover, most of this difference was due to a misreporting of the fiscal data rather than a mis-estimation of the underlying GDP. When Eurostat announced this to the financial community the following day, it included a footnote in the press release signaling its reservations "due to significant uncertainties over the figures notified by Greek statistical authorities".[6]

The Pasok government may have hoped to demonstrate that it had more integrity than its predecessor; instead what it underscored was the scope of the country's statistical and fiscal mismanagement. With each successive news story, confidence in Greek self-reported data diminished, and concern about the country's "true" fiscal situation grew. This dynamic took root because Pasok had confirmed what most financial actors already suspected, rather than surprising them with something that nobody knew. The ND government was forced to revise its fiscal estimates upward in October 2008 as well.[7] Moreover, the significance of this move was not lost on the markets. The Standard & Poor's rating agency downgraded Greece's creditworthiness in January 2009, citing concern over the structural weakness of the country's fiscal practices.[8] This set off a round of speculation, which sent Greek sovereign debt yields (or effective interest rates) to their highest levels compared to Germany since Greece joined the eurozone. That speculation only calmed down when the then German finance minister, Per Steinbrück, made it clear that his country would not stand by and allow another eurozone member state to go into default.[9]

Greece has a long history of poor accounting practices, dating back to the mid-1990s if not earlier. Eurostat has always had difficulties getting reliable data from the Greek government, and it was an ND government that first conducted a major restatement of public accounts in 2004.[10] Nevertheless, European bond traders hoped that participation in the eurozone would create both the opportunity and the incentives for Greece to get its fiscal house in order; or at a minimum, they assumed that someone would bail them out if

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they got into serious trouble. The gradual decline in the country's debt-to-GDP ratio since the early 2000s seemed to suggest that Greece was making headway on its fiscal consolidation, at least until the current crisis began to take its toll. As a result, the difference between Greek and German bond yields from early 2003 until March 2008 was less than 50 basis points, or one half of one percent.[11]

As the crisis set in, interest rates between Greece and Germany diverged as investors worried about Greece's fiscal prospects. Once reassured by German Finance Minister Steinbrück, however, the focus of market attention shifted from the incentives for fiscal consolidation to the prospect that any losses could be avoided through a bailout. Interest rate differentials between Greece and Germany peaked at over three percentage points on February 17, 2009, but then fell back by more than 60 basis points (or six-tenths of a percent) by early April. The point to note here is that Greek interest rates began to converge again on German norms during the late spring and summer of 2009, even as concern about Greece's fiscal practices continued to mount. Well before Pasok won the October elections, the International Monetary Fund published the results of its annual Article IV consultations, which made it very clear not only that "Greece needs a coherent fiscal adjustment path, based on durable measures", but also that "staff is concerned that large and growing data discrepancies . . . could harbor a worse underlying deficit than currently reported".[12] All the Pasok government did with its data revisions was underscore that such IMF concerns were justified. The markets were very slow to react. According to data from *Global Insight*, Greek ten-year government bonds yielded 4.66% on October 19, just days before the Pasok government submitted its revised deficit forecasts, and they yielded 4.63% on the day that those revised estimates were announced. It would be almost a month before Greek ten-year bonds crossed the 5% yield threshold, and it was only in December that market movements became severe.

Macroeconomic Imbalances

To understand why the markets took such a sanguine view of the Pasok government's Greek deficit revisions, and the poor state of Greek fiscal accounting more generally, it is necessary to look at how the eurozone member states have become financially interdependent as a consequence of their monetary integration. To begin with, countries that share a common currency are no longer constrained by international payments requirements – only the monetary union as a whole must worry about matching its assets and liabilities in relation to the rest of the world. Hence if Greece or any other country wants to import more than it exports, it can always borrow the money – in euros – from other countries in the eurozone. Similarly, if Germany or any other country wants to export more than it imports, it can always lend the excess money it receives – again, in euros – to other countries in the eurozone.

This notion of "excess money" is the predominantly confusing part. It is easy to see that a country that wants to consume more than it makes must borrow from abroad. If a country's income is limited to its output, and yet it wants to consume more than it produces, it obviously does not have the income, and so the money to purchase that excess consumption must come from somewhere else. The idea of "excess money" on the net exporting side of the relationship comes from looking at things the other way around. If a country wants to export some of its output, then it must consume less than what it produces, and therefore also less than what it earns. Indeed, that only makes sense because the country must be earning money on those goods that it produces and sells abroad (rather than at home). The problem is that this money cannot be used at home – otherwise, it would raise consumption (or physical investment) to match the level of output, and so eventually eliminate the trade surplus. Therefore that money must be sent (invested, lent) abroad.

The link between foreign lending and net exports is important because it makes it possible to tell the story starting with capital accounts rather than trade accounts. For this to make sense, however, it is necessary to dispense with the fiction that "countries" trade, and to instead focus on firms and individuals. Suppose German firms or individuals decide to lend some of their savings abroad, such as retained earnings or financial investments to be used later for education, health care, pensions, etc. The motivation for doing this is simply that they know that can get a higher rate of interest in other countries than they can get at home. Moreover, they believe that the excess rate of return more than exceeds the risk of putting their money in another country. This seems a particularly reasonable assumption when the other country uses the same currency as Germans do at home, so no matter what the rate of inflation over there, Germans know they will get the money back in euros that they can use at face value, without any exchange rate risk, for domestic consumption. This kind of thinking explains why the gap between German and Greek interest rates on long-term government debt collapsed from more than 20 percentage points in the early 1990s to less than one half of one percentage point in the early 2000s.

A consequence of this type of investment behavior – where Germans send some of their savings to chase higher interest rates in Greece – is that these same Germans are going to have to look for export markets to absorb some of their excess output. The reason they have to export more than they import is that the money they sent abroad was earned by generating output at home, and yet not spent on consuming that output either directly or in making a physical investment. Germany ran current account deficits in the 1990s when the gap between German and Greek interest rates was very high, and Germany ran current account surpluses in the 2000s after changing investment patterns with Germans investing Greek assets pushed interest rates in Greece to very low levels. Meanwhile, firms and individuals in countries like Greece were willing to pay higher rates of interest than in Germany, both because they have historically had much less access to credit, and because they paid more in terms of premia to cover the cost of inflation or exchange rate risk associated with their domestic currency. But once Greek firms and individuals began to borrow from abroad above and beyond their income, they also needed to buy goods from abroad because this new in-flow of credit had to be spent on something that the Greeks themselves did not produce. Actually, that is only half true. Some of that excess credit was used to purchase services that cannot be traded internationally and so as the demand for these services increased beyond Greek ability to supply them, inflation in

Greece accelerated as well. The reverse was true for Germany. Money sent abroad could not be used at home, and so demand for everything – not just tradable manufactured goods but services as well – declined. Inflation in Germany slowed down as a result.

Monetary integration brought German lenders and Greek borrowers together by lowering the risk associated with Germans lending to Greeks while at the same time lowering the cost associated with Greeks borrowing from Germans. Moreover, the same is true across the eurozone, with the consequence that numerous Austrian, Belgian, Dutch, German and French banks ended up lending vast amounts of money to firms and individuals in Greece, Ireland, Italy, Spain, and Portugal. Some of that money went to firms and individuals directly in the form of corporate borrowing or inter-bank lending; some went indirectly in the form of sovereign debts to finance government expenditures that otherwise would have to be paid for out of tax receipts. The symptoms of this exchange showed up in the form of current account balances and relative inflation rates. The borrowing countries showed relatively large current account deficits and high rates of inflation (because demand outstripped domestic supply); the lending countries showed relatively large current account surpluses and low rates of inflation (because supply outstripped domestic demand). Nevertheless, the eurozone as a whole worked almost as though it were a closed system with a balanced position on its current account transactions with the outside world and a relatively low rate of aggregate price inflation. In this sense, the lenders and borrowers in the eurozone were two sides of the same coin. No wonder that the lenders would expect the borrowers to be bailed out. If Greek borrowers defaulted on their debts, German lenders would suffer the losses. It only stands to reason, therefore, that the German government would have an interest in ensuring that did not happen. So long as everyone participated in the system and everyone continued to benefit, everyone had a reason to keep the system intact.

Halting Responses

The only problem with this logic is that the response of the eurozone governments to the Greek crisis failed to live up to market expectations. Everyone in the bond markets knew that there was a problem with Greek fiscal accounting, and few were surprised when the incoming Papandreou government announced that it would have to restate Greek accounts. That is why secondary markets for Greek long-term debt instruments were so slow to respond. Unsurprised is not unconcerned, however, and so market actors looked to political leaders in the eurozone to see how they would address the problem and whether, if necessary, Greece would be bailed out. What they saw was less than reassuring. A number of creditor countries, Germany foremost among them, expressed dismay that the Greeks had been so profligate. They criticized the Greeks for failing to abide by the rules for fiscal stability in the eurozone, and even more so for having failed to reorganize and rationalize control over their national statistics. Rather than embrace the new estimates provided by the Papandreou government, they questioned whether the Greeks can ever provide reliable fiscal data. And rather than accept Papandreou's admission that he would have to follow a policy of fiscal austerity rather than Keynesian reflation, they criticized Greece for failing to do enough.

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This criticism of Greece gathered momentum in November and early December of 2009. When the European Council met on December 10 and 11, the Greek crisis was not on the official agenda. Nevertheless, it was clear that the issue would be raised in the margins of the meeting. The results were disappointing in the markets. German Chancellor Angela Merkel came out of the meeting and made it clear that assistance for Greece was not on the table. Instead, she insisted, the Greek government would have to accept its responsibility for making sweeping structural reforms.[13] The bond markets were unimpressed. The more voices expressed criticism of Greece and the less likely it became that anyone would bail the Greeks out, the harder it became to find buyers for Greek debt instruments in secondary markets. Greek ten year bonds had a yield of just 5% in early December; by the 21st of the month, the yield on those bonds broke through 6%.

The situation stabilized in late December 2009 and early January 2010, but then darkened again about three weeks into the new year. Greek ten-year bond yields hit 6.23% on January 20 and then soared to 7.26% on the 28th. Already in early January, the European Council had agreed to address the issue in a special summit called by the newly installed Council President Herman van Rompuy. Given the obvious turmoil in the bond markets, this summit took on much higher significance. Nevertheless, the results were again less than hoped for by the markets. Although there were many expressions of solidarity with the Greeks, it was clear that the other EU countries continued to hold the Greek government responsible, and also that no firm commitment of support was on offer.[14]

Confusion over how much the other countries of the eurozone were willing to do to help Greece simmered through February and into March, although the stabilization of bond prices during that period suggests that on balance, bond holders were reassured. Moreover, whenever the Greek government went into the markets to issue new debt as part of its regular re-financing operations, it found much more demand than it expected. By the time of the spring European Council summit, however, the situation changed suddenly as the solidarity that had been expressed on February 11 unraveled. In its place, German Chancellor Merkel provided a clear statement of her conditions. Greece would only receive support in the event that financing via private capital markets is unavailable, and even then only on condition that the IMF participates as well.[15] These conditions injected real concern into the bond markets. If eurozone support would only be available after private financing had collapsed, then bond prices could have a long way to fall. And if the IMF would be brought in, there would be a very real chance that Greece could default. Greek ten-year bond yields stood at 6.14% when the March summit finished on the 26th. Those yields increased as Greek bond prices fell almost consistently from one day to the next, and by the 28th of April, Greek bond yields rose to almost 10 percent. The Greek government finally threw in the towel and called for eurozone support, because it feared that private sector financing for the new debt issues it had to post in May would not be available.

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Hard Constraints

If the lack of political support explains the turmoil in Greek bond markets, it is worth considering why politicians were not more forthcoming in their commitment to come to the aid of Greece. This is particularly true considering that much of the debt issued by Greece was held by other country's banks – France and Germany foremost among them. There are many good arguments to explain the situation. Three of the best among them are moral hazard, populist politics, and constitutional courts.

The moral hazard argument is straightforward. If Germany bails out Greece for becoming so heavily indebted this time, what is to prevent Greece or some other country from doing it again? Worse, as more and more countries take advantage of Germany's largesse, the result will be to increase government expenditure across the eurozone as a whole, and so run the risk of accelerating price inflation. This is why the European Union included a no-bailout clause in its provisions for economic and monetary union in the first place. It is also why it included a prohibition against excessive deficits, to which Germany insisted the EU member states add a stability and growth pact. Of course the fact that Germany itself was responsible for suspending the excessive deficit procedure in 2003 and reforming the stability and growth pact in 2005 does create some confusion. The perils of moral hazard are not limited to the Greeks. Nevertheless, it is clear that some rules need to be in place (and enforced) if the Greek crisis is not to be a harbinger of more widespread profligacy in the future.

The populist argument is more pointed and less ambiguous. Regrettably, much prejudice exists among Northern Europeans toward Southern Europeans, and particularly toward the Greeks. According to this prejudice, the South is lazy and corrupt while the North is hard-working and virtuous. Consequently, any Northern European politician who bails out the South risks being perceived as rewarding indolence and abetting corruption. Examples of this tendency are not limited to the German tabloid *Bild Zeitung*, but can be found across eurozone member states, from the Netherlands to Slovakia and all points in between. According to this line of argument, German Chancellor Merkel was most concerned about the consequences of aiding Greece for her party's performance in the regional election held on May 9 in North-Rhine Westphalia. This election was crucial to her control over the upper house of the German federal parliament; any bailout of Greece was wildly unpopular with the voters, and so the Chancellor had to appear tough on the Greeks to stand a chance at the polls. There is no doubt some truth to this argument – not least because the 2005 elections in that same region signaled the demise of the previous German Chancellor on the center-left[16] – but it is hard to see it as the principal factor. In any event, when the votes were cast on May 9, the German Chancellor's Christian Democrats lost more than 10 percentage points in support.

The constitutional argument is arguably more important.[17] In October 1993 and March 1998, the German High Court rendered decisions about the constitutionality of Germany's participation in the eurozone. The first decision made it clear that the European Union is a union of states, not of peoples, and so established that German

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constitutional law has priority over European treaty obligations (including those related to monetary union). That decision also underscored that any international monetary union must guarantee the same level of protection as the German currency. By implication, the euro must be as solid as the Deutschmark that it replaced. The 1998 decision reinforced these performance considerations. Germany could enter the eurozone, the court ruled, but only because strong guarantees for the price-stability of the euro remain in place. The prohibition of excessive deficits and the no-bailout clause are among the most important of those guarantees. Should German Chancellor Merkel show little regard for these restrictions by bailing out a profligate Greece, she would invite a challenge in the High Court – and there were many people queued up, including prominent economists, petitioning to make the case against her. An unfavorable decision by the German High Court would cast the eurozone into turmoil. German Chancellor Merkel's decision to set firm conditions for supporting Greece were designed to ensure that would not take place.

Contagion

The eurozone Finance Ministers met to respond to Greece's calls for financial assistance on May 2, 2010. They agreed to provide the country with up to €110 billion over a three year period, €30 billion of which would come from the IMF. They also set firm conditions for the fiscal consolidation that Greece would have to put in place. In the meantime, the European Central Bank agreed to lift any credit rating requirements for the use of Greek debt instruments as collateral in central banking operations. By implication, not only should the Greek government be out of the financial markets for new debt instruments, but the secondary market for existing Greek debt should remain liquid as well. The price tag was very high, both financially and in terms of ECB commitments. Nevertheless, it was enough to hold the Greek crisis at bay.

The only problem was that the crisis was never limited to Greece in the first place. Every part of the eurozone played a role in the redistribution of capital, and all were implicated in the macroeconomic imbalances that resulted. Greece was heavily indebted on its fiscal accounts, but Spain and Portugal were indebted in the private sector. Hence few actors in the financial markets viewed the European solution to the Greek crisis as credible. And as they worried about precisely which institutions were going to lose financially because of the wider implications, they began to panic. In this sense, Greece was very much like a European Lehman Brothers. The trillion dollar bailout announced on May 11 was the consequence, but that only treated the symptoms of the crisis, not the underlying problem. The "Greek" crisis may have ended, but we have a long way to go before we understand the full consequences. The next brief explains what those implications might look like.

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NOTES

1. "Press Release: Extraordinary Council Meeting, Economic and Financial Affairs, 9/10 May 2010," (Brussels: Council of the European Union, 9596/10 (Presse 108) Provisional Version, May 10, 2010).
2. The exchange rate data is taken from http://www.oanda.com for May 11. The euro strengthened against the dollar that day by two cents, only to fall back once questions began to arise about the details of the rescue package.
3. Press Release: 10 May 2010 - ECB decides on measures to address severe tensions in financial markets" http://www.ecb.int/press/pr/date/2010/html/pr100510.en.html
4. "Greece PM Confirms Election Date." http://news.bbc.co.uk/2/hi/europe/8234843.stm
5. The electoral and seat allocation data comes from Adam Carr's electoral archive: http://psephos.adam-carr.net/countries/g/greece/greece2009.txt
6. "Provision of Deficit and Debt Data for 2008 – second notification." *Eurostat Newsrelease: Euroindicators* 149/2009 (October 22, 2009). http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102009-AP/EN/2-22102009-AP-EN.PDF
7. Dermot Hodson, "The Euro Area in 2009: The Financial Crisis Gets Real," *JCMS Annual Review of the EU in 2009*, forthcoming.
8. Sam Jones, "S&P Downgrades Greece," *FTAlphaville* January 14, 2009. http://ftalphaville.ft.com/blog/2009/01/14/51146/sp-downgrades-greece/
9. Bertrand Benoit and Tony Barber, "Germany Ready to Help Eurozone Members," *Financial Times* (February 19, 2009).
10. "Report on Greek Government Statistics," (Brussels: European Commission, COM(2010) 1 final, January 8, 2010).
11. The bond yield data in this and the following paragraph is based on 10-year bid rates taken from Global Insight.
12. "International Monetary Fund: Greece, Staff Report for the 2009 Article IV Consultation," (Washington, D.C.: International Monetary Fund, June 30, 2009) pp. 1, 20.
13. "Pressekonferenz der Bundeskanzlerin nach dem Europäischen Rat," December 11, 2009, http://www.bundeskanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2009/12/2009-12-12-pk-bk-bruessel.html
14. Sean O'Grady and Vaness Mock, "Cracks Appear in Europe's Response to Greek Crisis," *The Independent* (February 12, 2010).
15. "Pressekonferenz der Bundeskanzlerin nach dem Europäischen Rat," March 26, 2010, http://www.bundeskanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2010/03/2010-03-26-pk-bk-bruessel.html
16. Klaus-Jürgen Nagel, "North Rhine Westphalia: The *Land* Election that Dismissed a Federal Government," *Regional and Federal Studies* 16:3 (September 2006) pp. 347-354.
17. This paragraph is adapted from Peter Ludlow, "In the Last Resort: The European Council and the Euro Crisis, Spring 2010," *Eurocomment Briefing Note*, 7:7/8 (June 2010).

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