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The Debt Crisis in the Euro Area: Interest and Passions

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As long as only a bank, an area of industry, or a neighbouring country were affected, we could pretend to be unaware that the crisis threatened the European Union itself. However, when it hit a country like Greece, a member of the euro group, it became self-evident that while Europe may not be to blame, it could well become the great global crisis's main victim. This paradox is due to the fact that, fully sixty years after it was first set up and despite its name, the Union is still in an intermediate state between disunity and unity. In particular, it lacks both the powers and the means for managing a crisis situation. This intermediate state can endure under normal conditions, but it cannot hold out under the enormous pressure of such a serious crisis as the one that we are currently going through. It is inevitably forced either to backtrack towards disintegration or to move ahead towards a fully-fledged union.

Thus Europe is once again facing both an opportunity and a risk at the same time. The Union today needs to complete its project, and thus it has an opportunity to do so. But a growing risk that protectionism and nationalism prevail over the European people's shared interest goes hand in hand with that opportunity. Signs of the disintegration of what has already been united have reared their heads on more than one occasion over the past few months. In the words of Jean Monnet: «*Europe will be forged in crises and it will be the sum of the solutions adopted for those crises*» (Memoirs, 1976).

The EU's heads of state or government are the ones who will have the final decision on which path to choose at this crossroads, but the Commission and the Parliament have both an opportunity and a duty to exercise an influence which may prove to be decisive. If the decision is based on the passions of nationalism or of economic dogmatism, then the Union will emerge mortally wounded. If, on the other hand, it follows the path of interest, then everyone (the EU, each member state, the people and businesses, the global economy) will emerge from this crisis with a stronger hope and stronger prospects.

The first imperative today is to stabilise the euro area. To achieve this, it is crucial for us to fully understand the stakes and economic choices facing us.

While no one can dispute the fact that the Greek authorities bear the principal responsibility for the collapse of market confidence in their country, we cannot deny that part of the blame lies with other member states in the euro area.

What is unfolding before our very eyes today is the result of several years of poor management of public finances and of competitiveness: on the part of Greece first and foremost, but also on other countries' part.

Under the former conservative government in Greece, from 2004 to 2009, the number of civil servants and their salaries rose astronomically and this in turn fuelled an exceptional increase in government expenditure. At the same time, trade union and political conduct caused the economy to suffer a major drop in its competitiveness. Thus Greece has been living beyond its means for the past few years, taking advantage of the low interest rates offered by its membership of the euro area. This poor management was compounded by an attempt to disguise certain figures in the statistics submitted to Brussels. Greece had quite clearly failed to take on board the constraints that come with membership of the single currency. A similar, if less serious, failure to take those constraints on board can be seen also in other countries that are exposed to the risk of contagion today.

Having said that, we have to recognise the responsibility of the other euro area members. This crisis could have been averted, or at least kept in check before it reached so acute a stage, if the euro area as a whole (in other words, the member states plus the Union's institutions in their entirety) had avoided making some serious faults of omission. The thing that has been most noticeably lacking is the effective functioning of peer pressure as a factor for discipline and as an encouragement for all of the Economic and Monetary Union's members to adopt good practices in their economic policies.

The collective monitoring mechanisms have not worked as they should have done because each member state preferred not to interfere in the others' conduct rather than monitoring that conduct and running the risk of being monitored in turn. The single currency's first decade of life has been characterised by a morose attitude: do not disturb so as not to be disturbed. We cannot ignore the fact that this morose attitude was set in motion when the two offending countries were France and Germany: in 2005 the two countries – which were not complying with the budget deficit ceiling set by the Stability and Growth Pact – managed to avert the sanctions provided for under the Pact. In allowing them to do so, the Council relinquished its disciplining function and offloaded onto the markets the job of calling to order any countries that were living beyond their means.

In this connection it is worth citing a particular episode.

In 2004 the European Commission noticed that the results on the basis of which Greece had been admitted into the euro area rested on falsified statistics: the Greek public deficit had been approximately 2 percentage points of GDP higher than the figures that Greece had sent Brussels for every single year between 1997 and 2003, and in every instance it was more than 3 % of GDP. When this falsification of the statistics became public knowledge and the first 'Greek affair' erupted, the Commission submitted a proposal for a regulation (March 2005) designed to empower Eurostat to conduct on-site inspections of national statistics. The Council rejected the proposal. The member states, including Germany, did not want to see Eurostat playing the policeman with their accounts because they felt that that would be detrimental to their national sovereignty.

In February 2010 the Commission submitted a new proposal for a regulation that was almost identical to the one submitted in 2005, designed to ensure the reliability of national public accounts figures and to empower Eurostat to audit those figures. Thus we may hope that, having reached its present crossroads, the EU will seize the opportunity that the crisis has offered and will strengthen the EU and the euro area.

In short, when seeking where to apportion blame for the Greek crisis, we must look to Athens, of course, but also to Brussels, to Berlin, to Paris, and to every other European capital.

It would have been a fatal error to decide to abandon Greece to its fate and not to offer it an outstretched hand, as though failure to help the country would affect Greece alone. In the event of bankruptcy, losses would have been suffered by all those savers and investors that hold Greek bonds, almost half of whom are French (17%), Germans (10%), Italians (7%), and from the Benelux countries (approximately 5% each), etc. This, not to mention the risk of a domino effect on other euro area members, or of the impact that it would have on the common currency's stability. And when the euro finally came under threat, it would be the currency of the Germans, of the French and of the entire euro area that would be in danger, not just the currency of the Greeks.

That fatal error has been averted, but we need to ask ourselves why it was so warmly urged by influential personalities and why such a strong temptation to fall into the error prevailed for such a long time. The reason lies quite simply in the unshakable illusion that it is possible to enjoy the benefits of both independence and interdependence at one and the same time. It lies in a passion that prevails over interest and over reason: the myth of the nation state's absolute sovereignty is deeply rooted in our culture, and the political classes cling to it so tenaciously that they end up flying in the face of the evidence.

The crisis has finally alerted those who had not yet woken up to the fact, that interdependence has developed to such a degree that all of the Union's member states – the strong and the weak, the virtuous and the sinners – have now lost their full economic, and even political, sovereignty. The less than virtuous countries, those whose public finances and competitiveness are in a sorry state, no longer have sovereignty because their economic, social and budget policies are dictated by the obligation to adjust those policies enforced on them both by the markets and by the treaties. Nor, despite several claims to the contrary, would they return to enjoying full sovereignty even if their exchange rates could be altered by comparison with the rest of the Union or of the euro area. And as for the so-called 'strong' countries such as Germany, they are not sovereign either because the degree to which they are the indebted countries' creditors and suppliers means that their savings and jobs are held hostage by those countries termed 'less than virtuous'. Despite the commonly held belief that independence and sovereignty are guaranteed for those who say «*we keep our own house in order and if others do not, then too bad for them* », it is not sufficient to keep one's own house in order to be protected from the consequences of others' failure to do so. In short, no countries can be both independent and interdependent at the same time!

In view of the economic interdependence existing among the EU member states, and in view of the fact that half of Greece's debt is held by savers from outside the borrowing countries and that the threatened currency is the currency of a huge region comprising sixteen countries, we have no choice but to conclude that Greece's difficulties are the Union's problem, not simply the problem of one of its members. To see collective intervention in aid of a member in dire straits as an act of generosity on its partners' part and to then wonder whether the country in question deserves such generosity is not the right way of looking at the matter at all.

Let there be no misunderstanding: solidarity is a crucial component part of the European construction process, as indeed it is of any political community; but what is principally at stake for the Union's member countries in this crisis is not generosity, it is their interest.

Proper management of the debt crisis in Europe means avoiding two pitfalls, both of which are equally catastrophic on account of the domino effect that they would entail: inaction, which would allow a country to drift into bankruptcy, or the exact opposite, a free bailout which would reward its mistakes instead of punishing them. In the wake of inaction, other countries would be threatened by the same bankruptcy; following a free bailout, all economic discipline would be lost. Only intervention on the Union's part – naturally reflecting the interest of the country involved, but justified also by that of the other partners – can forestall the first domino effect, in other words that of other economies being contaminated by the bankruptcy of one of their number. But if that intervention were to be a remission rewarding bad policies, then this would trigger the second domino effect, because the example would rapidly spread to other economies requiring a budget adjustment and a return to competitiveness.

Is there a narrow path between these two pitfalls? Several schools of thought claim that no such path exists, and so we shall examine their arguments one by one.

Some people consider Greece's debt to be so large and the adjustment effort so painful that the recovery plan would freeze all growth and would consequently prevent the creation of the revenue which the country needs to service the debt and to bring that debt down. According to this school of thought, an aid plan would be bound to fail. Rather than resorting to public-sector aid, Greece should restructure its debt, which would mean enforcing losses on its creditors; and it should also leave the euro area in order to be able to devalue and to thus re-establish its competitiveness.

This vision – which considers the worst-case scenario as unavoidable – is unfounded. Experience shows that the task is possible. Other EU member states have been through situations which the pessimists judged to be just as hopeless as Greece's situation today, but events have given them the lie. A striking example comes from Belgium, which eased the burden of a huge public debt in the space of a few years thanks to a few energetic decisions. In the early nineties its debt stood at 130 % of GDP, but by 2007 that had shrunk to a mere 80 %. The budgetary abscess began to heal in the mid-1990's with the implementation of a 'Grand Plan' promoted by Prime Minister Jean-Luc Dehaene and by the then Budget Minister Herman Van Rompuy, who is the president of the European Council today. That plan, adopted as the country was dragging itself out of a recession, did not entail a devaluation of the currency; rather, it consisted in raising taxes while cutting back on expenditure.

Another school of thought suggests that no narrow path exists because all aid is a form of remission, thus it is not only an economic policy error but also the starting point for the second domino effect. The underlying flaw in this reasoning is its failure to distinguish between a loan and a gift.

In actual fact, it is by no means true that financially aiding an indebted person inevitably consists in wholly or partly remitting his debt and in offloading the cost of that remission on a third party, in this case the non-Greek taxpayer or saver. On the contrary, only if the member states decided to allow their debtor to drift toward bankruptcy would they be giving up on a part of their credits, and only in that case might we accuse them of making their debtor a 'gift'. In that case, the euro area would be making Greece the 'free gift' of allowing it to default on payment. That default would inflict losses on the creditor countries, and above all, it would trigger the second domino effect because other countries in difficulty would expect to be afforded the same degree of generosity.

Between the two pitfalls, there exists the possibility of aid in the shape of well-constructed conditional loans whose effect is to allow Greece to honour its debt. The terms of this aid must, of course, consist in a recovery plan offering a genuine prospect of re-establishing the ability to pay the loans back. If that happens, then we cannot call the process either a gift or a bailout.

In conclusion: there actually is a narrow path that makes it possible to avoid the two domino effects. And experience gives the lie to the contention that a devaluation of the currency would be crucial to avoid bankruptcy.

Here are two further considerations on the narrow path.

The first concerns the interest rate at which the aid is offered. It is only natural that that rate be situated within a bracket whose outer limits are the rate at which the lenders (the European Union, its member countries and the International Monetary Fund) borrow in their turn, and the rate that the market demands of Greece at that moment. Naturally, for a country in difficulty which has lost the markets' confidence, that bracket is going to be exceptionally wide: indeed that is one of the reasons why aid from public-sector lenders can be crucial, justified and advantageous both for the lender and for the borrower. The point in the bracket at which the interest rate for the aid ends up being set in practice can only be the result of a political decision. That rate must neither be so high that it puts the borrower in a position where he is faced with a burden which, of itself, makes him insolvent, nor yet so low that it becomes a form of subsidy. If the terms of this credit were to be excessively harsh, the lender would be in danger of killing the patient with the weight of the expense that he is obliging him to bear by offering him additional credit. We cannot ignore the fact that the unsustainability of a country's situation may also be caused by excessively harsh aid terms.

The second observation concerns the time frame for emerging from the crisis. We need to be aware of the fact that under no circumstances are we looking at a one-act play. It will be played out in stages over several years. No country that has allowed its situation to sink to such dramatic depths over so many years can recover in one fell swoop. A country in that condition is facing a marathon, not a 440-yard race. The drama is political and social at least as much as it is economic and financial. A recovery plan has to be approved and implemented, in the knowledge that such deep-seated adjustment normally stretches over about ten years and that, during that time, the force of inertia triggered by the first package of measures is insufficient; that package has to be adapted to the economic context and to political change.

The EU's Response

In stating on 11 February that the euro area member states «*will take determined and coordinated action, if needed, to safeguard the financial stability in the euro area as a whole*», the European Council stated quite clearly that it was not just Greece that was threatened but the euro area as a whole, the euro itself and the credibility of the entire European construction process.

The European Council's spring meeting (25 and 26 March) reiterated that initial pledge and translated it into a mechanism for aiding Greece comprising European funding through coordinated bilateral loans and minority participation on the International Monetary Fund's part. I think that the EU-IMF formula was the right one. The Union could neither cold-shoulder the IMF nor delegate all responsibility to it. Given that it was a matter of safeguarding a common construction and its currency – the euro – the Union could not allow itself to be replaced by the IMF in performing that task. But at the same time, it was advisable to make the best use of the IMF's technical expertise and reputation for independence.

On 2 May, following a request submitted by the Greek Government on 23 April, the mechanism outlined in the statement issued by the euro area's heads of state or government leaders on 25 March was finally set in motion. To quote the statement issued by the Eurogroup on 2 May: «*Eurogroup Ministers concur with the Commission and the ECB that market access for Greece is not sufficient and that providing a loan is warranted to safeguard financial stability in the euro area as a whole. Following a request by the Greek authorities, euro area Ministers unanimously agreed today to activate stability support to Greece (...)*».

In order to ward off the danger of the Greek crisis contaminating other member states, the members of the Eurogroup decided on 7 May to add a new measure to the program in support of Greece, in order to preserve financial stability in the EU: the establishment of a European stabilisation mechanism resting on European Union financial assistance on the one hand and on a stabilisation fund on the other, with an overall value of some 750 billion euro. This mechanism, based on Article 122, Paragraph 2 of the Treaty and on an intergovernmental agreement among the euro area members, was adopted by the ECOFIN Council members at their extraordinary meeting on 9 May.

Moreover, in the wake of this broad plan, the ECB also adopted some accompanying measures. In particular, the Governors' Council, meeting in Lisbon on 6 May, decided to temporarily revive its mutual currency exchange mechanism (swap lines) with the US Federal Reserve, and to intervene on the public and private debt market to bring liquidity and funding to the markets damaged by the crisis. On 18 May the ECB launched a special refinancing operation over a week to absorb the additional liquidity on the markets fuelled by its euro area public debt buyback program.

The coordinated initiatives of the Eurogroup, the European Commission, the Council and the European Central Bank prove Europe's determination to face the crisis and to endow it with the financial means to stave off the threats looming over financial stability in Europe.

In short, in its management of the Greek crisis, the Union has taken the right path. Its action is neither an act of generosity nor a gift to Greece; it is an act that enables it to defend the interest of the euro area and of its member states.

Yet we must reproach the Union for advancing too slowly, without the capacity for rapid reaction or the determination that would have been necessary to calm the markets and to prevent the situation from deteriorating and from starting to contaminate other economies.

In recent months the markets have been destabilised not only by the fragility of Greece's situation but also because each positive step forward – in particular, the statements on 11 February and on 25 March – has been followed by negative considerations and stances that have rekindled doubt. The mechanism devised by the heads of state or government on 25 March had a pre-emptive goal which consisted in tranquilising the markets so as to allow Greece ease of access to the market and to thus avoid the need for Union intervention. However, the positive effect was immediately countered by statements, coming in particular from Germany, that managed to rekindle investor mistrust once again.

Germany's position has been rightly criticised over the past few months, but we have to understand it. While it is true that Berlin's hesitancy has irritated the markets and made Greece's support more expensive, the German chancellor's action needs to be set in its proper German context. No country in the EU has ever given up sovereignty to the same extent as Germany did when it accepted the euro: for France to have given up its sovereignty to the same extent, it would have had to assign control over its nuclear deterrent to the Union. It was a painful move and it is a falsehood to claim that that move was the price of German reunification: when Helmut Kohl launched the blueprint for a single currency, no one imagined that the Berlin Wall would fall. No country in the Union has taken the imperative of excellence and of competitiveness as seriously as Germany has: can we blame it for reaping the rewards of that attitude? No trade union movement in Europe has opted so clearly to afford priority to full employment over pay rises: can we consider that a fault? No major industrially advanced country has accepted, to the extent that Germany has, the constraints of global economic growth that is sustainable from the economic, social, and environmental standpoints: sobriety in opulent consumption, savings in the field of natural resources, clean energy, containing public spending, and social harmony. Proposing and approving a mechanism in support of a country that has been living beyond its means is an act of immense political courage and we should not be surprised that it was so difficult to achieve.

Conclusion

I shall wind up my discussion with a metaphor. If the EU is a condominium in which one of the owners has set fire to his apartment through his own carelessness, the neighbours have nothing to gain by barricading themselves in their own homes, covering their eyes with their hands and leaving the neighbour in the lurch to suffer the consequences of his mistake on his own. This, because all of the owners are going to suffer damage from the fire, albeit to a varying degree, and the more the fire spreads, the more serious the consequences are going to be. Thus it is necessary to help the neighbour to put out the fire before his apartment burns down completely, and in such a way as to ensure that the person who started the fire pays for the damage that it has caused to itself.

Once the fire is under control, it is going to be necessary to identify the causes of the incident and to take measures to ensure that it cannot happen again. The European Commission's communication on reinforcing economic policy coordination submitted on 12 May, and the establishment of a working group chaired by European Council President Herman Van Rompuy tasked with submitting measures designed to boost capacity for monitoring, preventing and managing crises to the Council before the end of the year, are moves in that direction. So we may hope that, in the risk and the opportunity that this crisis has created, the EU member states have managed to ward off the threat looming over the EU while, at the same time, seizing the opportunity to strengthen both the EU and the euro area ■

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« Euro remains on the right side of history »

Over many months, a mighty army has advanced on the citadel of the European currency with the cry: «It will never work!» The army was quick and single-minded, the citadel slow and divided. The besiegers were thousands, steeled by convictions all the more fervent for their extreme simplicity. Their reasoning was as follows: the euro area is not a political union and can never become one, because Europeans have no appetite for it and nation-states will not relinquish power. The citadel, therefore, is doomed to capitulate and its stubborn resistance merely serves to create profit opportuntes for astute traders...

Article published in *Financial Times*,13 May 2010.

« Deutschland, die Schattenlinie - *Germany, the shadow line* »

In wenigen Tagen wird die deutsche Regierung dem Bundestag den Kredit für Griechenland vorschlagen. Sie wird es tun, obwohl die Märkte darauf wetten, dass er nicht zurückgezahlt wird, obwohl die Rating-Agenturen das Land genau dann herabstufen, als Athen härteste Maßnahmen absegnet, obwohl illustre Ökonomen Griechenland dazu aufrufen, seine Schulden nicht zurückzuzahlen («die geordnete Restrukturierung») oder sogar aus dem Euro auszutreten. Es ist erstaunlich, dass die Märkte, Agenturen und sogenannte Experten immer noch soviel Vertrauen genießen, nachdem die Krise ihre Kurzsichtigkeit, ihre Fehler und ihren Konformismus brutal ans Licht gebracht hat.

Article published in *Handelsblatt*, 13 May 2010 and *éditorial* published in *El Corriere della Sera*, 1st May 2010.

Contre la courte vue : entretiens sur le Grand Krach

« On ne peut pas réfléchir sur la sortie de la crise si on ne comprend pas la crise en elle-même. Son essence est économique et sociale. Ce qui a fait défaut au système économique, c'est la charpente de règles, de contrôles et d'actions gouvernementales qui, dans une économie de marché, constitue l'indispensable complément de la libre recherche du profit par les individus et les entreprises. Cette crise est en réalité politique et institutionnelle : l'échec dont elle résulte est davantage celui de la politique éconimique que celui de la finance et des marchés. Enfin, et de manière plus générale, la crise trouve ses racines sur le terrain de la culture, intellectuelle et anthropologique : il découle d'attitudes mentales, d'idées et de comportements devenus dominants dans nos sociétés.

Observer le présent comme un événement historique signifie regarder les faits pour comprendre 'comment vous voudrions que cela se passe'. Les regarder pour chercher la synthèse entre ce que nous voulons et ce que nous pouvons.»

Contre la courte vue : entretiens sur le Grand Krach, Tommaso Padoa-Schioppa with Beda Romano, Odile Jacob, 2009.

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