

## The Greek crisis and the future of the Eurozone

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The crisis that started in Greece culminated into a crisis of the Eurozone as a whole. There is no doubt that the major responsibility rests with the Greek authorities who mismanaged their economy and deceived everybody about the true nature of their budgetary problems. The solution of the problem will therefore necessitate drastic changes in Greek economic and budgetary policies. This being said, there is more than one villain in the play. The financial markets and the eurozone authorities also bear part of the responsibility for letting this crisis degenerate into a systemic crisis of the eurozone.

The destabilizing role of financial markets has been illustrated dramatically again. Periods of euphoria alternate with periods of depression amplifying movements in asset prices that are unrelated to underlying fundamentals. This is not new, of course, but the speed with which this has occurred is baffling. Just a year ago the sovereign bond markets were gripped by a bubble leading to record low levels of long term interest rates at the time when governments added unprecedented amounts of new bonds in the market. In a few weeks time the situation turned around dramatically and bond markets in a number of countries crashed. It is a repeat of a sad story. Financial markets are first blinded and see no risks, until the wake-up call and then they overreact making the resolution of the problem more difficult.

The rating agencies take a central position in the destabilizing role of the financial markets. One thing one can say about these agencies is that they systematically fail to see crises come. And after the crisis erupts, they systematically overreact thereby intensifying it. This was the case two years ago when the rating agencies were completely caught off guard by the credit crisis. It was again the case during the last few months. The sovereign debt crisis started in Dubai. Only *after* Dubai postponed the repayment of its bonds and we had all read about it in the FT, did the rating agencies realize there was a crisis and did they downgrade Dubai's bonds. Having failed so miserably in forecasting a sovereign debt crisis, they went on a frantic search of possible other sovereign debt crises. They found Greece which of course was a natural target. They did not limit their search to Greece but "visited" other countries, mostly Southern European countries and started the process of downgrading. This in turn led to a significant increase in government bond rates in these countries.

The crisis was allowed to unfold also because of hesitation and ambiguities by both the Eurozone governments and the ECB. The Eurozone governments failed to give a clear signal about their readiness to support Greece. The failure to do so mainly resulted from disagreements among member state governments concerning the appropriate response to the Greek crisis.

The ECB, in turn, created ambiguities about the eligibility of Greek government debt as collateral in liquidity provision. As is well-known, the ECB relies on ratings produced by American rating agencies to determine eligibility of government bonds as collateral. Prior to the financial crisis the minimal rating needed to be eligible was A- (or equivalent). In

order to support the banking system during the banking crisis, the ECB temporarily lowered this to BBB+. At the end of 2009, however, the ECB announced that it would return to the pre-crisis minimal rating from the start of 2011 on. As the Greek sovereign debt had been lowered to BBB+, this created a big problem for financial institutions holding Greek government bonds, which now face the prospect that their holdings of Greek government bonds may become extremely illiquid. No wonder many dumped Greek government bonds, precipitating the crisis. Similar uncertainties about the future ratings of other Eurozone government bonds hang as a sword of Damocles over the Greek government bond market and more generally over the government bond markets of the weaker countries in the Eurozone.

### **What's to be done: the short-run**

The Greek government debt crisis should be stopped. There are at least three reasons why it is imperative that this crisis be stopped. First, allowing the Greek crisis to lead to default, risks leading to contagion that will affect other government bond markets in the eurozone. Second, and following up on the previous statement, such a contagion to other government bond markets will affect the banking sector in the Eurozone. Many banks have started to recover from the banking crisis by arbitraging the yield curve, i.e. by borrowing short from the central bank at very low interest rates and investing in longer term government bonds. The steepness of the yield curve has been an important source of profits for the banks. A crisis in the government bond markets, i.e. sharply declining bond prices, would lead to large losses on the balance sheets of the banks. This could trigger a new banking crisis in the Eurozone.

A third reason for the need to stop the Greek government bond crisis is at least as important. If not stopped, the crisis will lead to increases in government bond yields in a significant number of Eurozone countries. This will put pressure on the governments of these countries to sharply contract fiscal policies, leading to deflationary effects and risking to pull down the Eurozone economies into a double-dip recession. Such an outcome would not only be bad news for the unemployed, but would also make it even more difficult for the Eurozone countries to reduce their budget deficits and debt levels.

The choice the Eurozone authorities face today is between two evils. The first one arises from moral hazard. Bailing out Greece is bad because it gives a signal that irresponsible behaviour will not be punished. The second evil arises from the contagious effects of letting Greece default on the banking system and macroeconomic policies in the Eurozone. Authorities have to choose for the lesser evil, which in this case is the second one. This is also what they did when they bailed out the banks that had been at least as irresponsible as the Greek government.

While there can be little doubt that the crisis must be stopped now rather than later, much doubt has been voiced that the European Union, or for that matter the member countries of the Eurozone, have the means to do so. Doubts have been voiced at the legal level and at the level of the financial capacity of the union to organize a bail-out.

The legal skeptics argue that the no-bail out clause in the Treaty forbids the member states of the union to provide financial assistance to another member state. But this is a

misreading of the Treaty. The no-bail-out clause only says that the European Union shall not be liable for the debt of governments, i.e. the governments of the Union cannot be *forced* to bail-out a member state (see Article 103, section 1). But this does not exclude that the governments of the EU freely decide to provide financial assistance to one of the member states. In fact this is explicitly laid down in Article 100, section 2<sup>1</sup>. Thus euro zone governments have the legal capacity to bail out other governments.

There can be equally little doubt that the Eurozone member countries have the financial capacity to bail-out Greece if the need arises. It does not cost them that much. In the event that Greece were to default on the full amount of its outstanding debt, a bail-out by the other euro zone governments would add about 3% to these governments' debt. A small number compared to the amounts added to save the banks during the financial crisis.

One can conclude that the member countries of the Eurozone have the legal and financial power to bailout Greece. Up to now the only obstacle has been political, i.e. the lack of consensus among the different member states about the necessity to do so. One can only hope that this political obstacle will go away soon. The Greek government of course has the key to eliminate the obstacle by providing a credible budget cutting policy. This seems to be the case today after the new round of budget cutting measure. It is unclear though whether the other EU countries are willing to take up their part of the deal.

There is one important element missing, though. This is an announcement by the ECB about its collateral policy. As argued earlier, the uncertainty about what the ECB will do in the coming months with Greek government debt remains. The ECB should clearly signal that it will continue to accept Greek government debt as collateral, independently of the ratings concocted by the agencies.

The experience we now have with the ECB policy regarding the eligibility of government bonds as collateral in liquidity provisions leads to the conclusion that there is an urgent need for the ECB to change this policy. More precisely, the ECB should discontinue its policy of outsourcing country risk analysis to American rating agencies. The latter have a dismal record. As argued earlier, they have made systematic mistakes, underestimating risks in good times, and overestimating risks in bad times. Relying on these agencies to decide about such a crucial matter as the selection of government bonds, is simply unacceptable. It helps to destabilize the financial markets in general and the Eurozone in particular. Surely, the ECB should not be a primary source of financial instability in the Eurozone. The ECB is better placed to do the job of analyzing the creditworthiness of member countries of the Eurozone than the rating agencies. It has a pool of highly skilled analysts who are equally capable if not more so than the analysts working for the rating agencies.

### **What's to be done: the long term**

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<sup>1</sup> Here is the text: "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, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned".

The crisis has exposed a structural problem of the Eurozone that has been analyzed by many economists in the past. This is the imbalance between full centralization of monetary policy and the maintenance of almost all economic policy instruments (budgetary policies, wage policies, etc. ) at the national level.

Put differently the structural problem in the Eurozone is created by the fact that the monetary union is not embedded in a political union. This imbalance leads to a dynamics of creeping divergencies between member states and no mechanism to correct or to alleviate it. These divergent developments have much to do with the fact that important economic decisions (decisions about wage agreements, budgetary policies, social policies, credit regulations, etc. ) are decided at the national level.

These divergent movements in competitiveness also lead to budgetary divergences whereby countries that loose competitiveness experience stronger deteriorations or their budgetary situations. Thus the lack of political integration leads to a buildup of economic and budgetary divergencies leading to a crisis. When the crisis erupts, the same absence of political integration makes it difficult to resolve the crisis as was illustrated in the previous sections.

This structural problem has to be fixed before we are hit by the next crisis. But that is also the hard part. There is today in the Eurozone no willingness to move forward into a more intense political union. Even the thought of adding just 0.1% to the European Union budget makes some countries extremely jittery. Thus, a very small scale fiscal union that would transfer just a few percentage points budgetary and tax responsibilities appears to be out of the question.

One is led to the conclusion that the inability to create a more intense political union in the eurozone will continue to make the latter a fragile construction, prone to crises and great turbulence each time such a crisis must be resolved.

While a grand plan for political unification does not seem to be possible, smaller but focused steps towards such a future union can be taken. Two such steps are worth mentioning here. One is the idea of creating a European Monetary Fund (EMF), an idea put forward by Daniel Gros and Thomas Mayer. The EMF would be a new European institution which would obtain its funding from countries with excessive budget deficits and debt levels. In times of crisis it would have the means to support countries in need of financial assistance, while at the same time it would have the authority to impose conditions for the granting of financial assistance.

Another idea is to create new common Euro government bonds in which each country would participate pro rata of its capital share in the ECB (for more detail see De Grauwe and Moesen(2009)). In order to deal with obvious moral hazard problems, the interest rate each of the participating countries would have to pay would depend on the interest rates each of these governments pay when they issue bonds in their own markets. Thus the more profligate governments like Greece would have to pay a higher interest rate than the more orthodox governments. The common bond interest rate would then be the weighted average of these national interest rates. Such a scheme would go a long way in pacifying the fears about moral hazard implicit in common bond issues; fears that are very strong in countries like Germany. In addition, by creating a new bond market with

sufficient size it would also be attractive to outside investors, creating a liquidity premium that would profit everybody, including Germany.

These proposals are only small steps towards political unification. They have the important quality of being signals of a determination of the members of the eurozone to commit themselves to a future intensification of the process of political union. Such signals are of crucial importance today. They make it clear that the members of the eurozone are serious in their desire to preserve the eurozone. Without these (or similar) steps there can be little doubt that the Eurozone has no future.

*References:*

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