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Policy options for Greece – an evaluation

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Introduction

Since the start of the European Monetary Union (EMU), there has hardly ever been such an intense discussion on a governance problem within the currency area as is the case over the Greek default risk at the moment. Political analysts, economists, present and former political leaders and central bankers engage in an unparalleled way in the EMU governance debate.

After weeks of contradictory statements on the question of how to handle Greece, the Heads of State and Government of the EU member states used their informal European Council meeting on February 11th for a strong political signal that aimed at calming markets and giving political support to the Greek Prime Minister's budgetary consolidation efforts and structural reform programme. The subsequent meeting of the EU's Finance Ministers on February 16th meanwhile increased pressure on the Greek government for further consolidation, taking the Excessive Deficit Procedure to its next step in which the Finance Ministers issue precise recommendations for Greece and increase surveillance in the country.

The European Council's announcement that the EU "will take determined and co-ordinated action, if needed, to safeguard financial stability in the euro area as a whole"[1] was widely interpreted as a bail-out promise. But only a few days after the summit, new doubts arose whether the EU or its larger member states, in particular Germany, would indeed step in for Greece.

Despite increasing market instabilities and the rapidly approaching moment of truth when Greece will have to refinance around 25 bn € of its sovereign debt in April/May 2010, the options that are discussed still range from a sovereign default and a Eurozone exit to a strong engagement of the EU and the creation of new crisis management and co-ordination mechanisms for the Eurozone, or an IMF intervention.

This is not surprising, as there is no cheap and safe solution. Any political choice in this current situation has downsides. And no matter how the Greek case is handled, it will be a precedence for future cases of EMU governance.

The following paper assesses four – arguably simplified – policy options for Greece with regard to their pros and cons. We take into account the longer term implications for EMU governance in particular with regard to the further problematic cases looming on the horizon. For each option, we also discuss the political feasibility and likelihood.[2]

[1] Statement by the Heads of State or Government of the European Union, Brussels, 11 February 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/112856.pdf, last download March 17, 2010.

[2] Part of this paper draws on a joint article with Sebastian Dullien: How should the Eurozone handle Greece? Published on March 1st, 2010 on Eurointelligence, http://www.eurointelligence.com/article.581+M539752bc904.0.html, last download March 1, 2010.

Option I: The default option

Greece gets neither liquidity help, nor credit, nor gifts from the EU partners – and defaults in a disorderly way on its debt in the course of 2010.

The pro arguments

- Proponents argue that this is the only solution that prevents moral hazard. Meanwhile, any financial assistance from the EU partners will increase the moral-hazard-problems inherent in the construction of the EMU. In particular, Spain (or Portugal or Ireland) could become a "second Greece" if a lack of reform efforts is "compensated" by a rescue package.
- The default option could hence help discipline member states to conduct structural reforms and increase productivity in order to improve their competitiveness and to pursue sound public finances. By not giving a bail-out promise, the fellow EU-member states would increase the role of market pressure which has only insufficiently functioned since the single currency was introduced. This fact, combined with a growing perception that self-discipline is necessary would lead to better results than the current policy coordination mechanisms.
- Not supporting Greece would be true to the "No-bail-out-clause" of the Maastricht treaty (now Article 125 of the TFEU) which is a fundamental element of the Eurozone's architecture and hence the legal base upon which the 16 member states decided to give up their national currency. For instance the German Constitutional Court pointed out that this concept of EMU as a stability union (based on elements such as the No-Bail-Out-Clause, the independence of the ECB, etc.) is the legal base and substance of the legal act ratifying the Maastricht Treaty in Germany.[3]
- Given the high costs for tax payers in other EMU countries, a bail-out of Greece would be perceived as being illegitimate. Estimates for the costs of a bail-out that may become necessary in April/May 2010 range from 20 to 25bn €[4], but in order to assure long-term sustainability much larger sums might be needed. Opinion polls show very clearly that a large majority of citizens is opposed to paying for what is perceived as being the mistakes of other governments which they cannot vote out of office.[5] The fact that the Greek government has used false

[3] See the court ruling BVerfGE 89, 155 – Maastricht. The original quote reads: „Diese Konzeption der Währungsunion als Stabilitätsgemeinschaft ist Grundlage und Gegenstand des deutschen Zustimmungsgesetzes. Sollte die Währungsunion die bei Eintritt in die dritte Stufe vorhandene Stabilität nicht kontinuierlich im Sinne des vereinbarten Stabilisierungsauftrags fortentwickeln können, so würde sie die vertragliche Konzeption verlassen."

[4] First reports were published by the German news magazine Der Spiegel: http://www.spiegel.de/wirtschaft/unternehmen/0,1518,679222,00.html

[5] See for instance the Open Europe poll of German voters http://www.openeurope.org.uk/media-cnetre/pressrelease.aspx?pressreleaseid=117 or the

budget data to get into the EMU and to prevent sanctions under the Stability and Growth Pact (hence making its preventive arm dysfunctional) strengthens this point.

The counter arguments

- Letting Greece default may provoke self-fulfilling speculation against other vulnerable countries such as Portugal, Ireland and Spain, all of which are vulnerable with double digit budget deficits which need to be financed. In contrast to Greece, Spain is relatively large and a default would send a shock through financial markets. This could seriously hurt economic growth in Europe. The EU would risk to be politically destabilized.
- Repercussions on the EU banking sector would be serious. Most of Greece's government debt is held abroad, more than €200bn by European banks. According to estimates, German banks hold about €30bn, French banks around €55bn. Banks' losses would lead to a loss in government revenue in the other countries. Even worse problems would arise in the case of a Spanish bankruptcy, which, as argued above, could be a second effect of a Greek default.
- A default would severely weaken the Greek government, possibly driving it out of office. It would become harder if not temporarily impossible to implement budgetary consolidation and structural reforms in Greece.
- The problem of Greece's lack of competitiveness would not be solved. The default would not be accompanied by a unilateral currency devaluation unless Greece decides to leave the EMU. While the Euro would probably devalue further, Greece's weak competitiveness position *within* the Eurozone would not improve.
- A disorderly default could create so much political turmoil in Greece that the country decides at some point to leave the euro in a disorderly depreciation parallel to that of Argentina in 2001.
- A sovereign default would harm the EU's image in the world in political, economic and financial terms. In order to prevent a default, the Greek government could turn to the IMF for loans – which is a scenario that many perceive as being a failure of the Eurozone to deal with its internal problems (see Option II below).

Assessment of obstacles, political feasibility, likelihood

Despite strong proponents of the No-Bail-Out scenario (for instance in the European Central Bank (ECB)) this seem to be the most unlikely scenario. Greece will most probably be bailed out because the risks of a banking crisis and a contagion to other highly indebted member states are taken seriously among policy-makers. The recent statements by the European Council of February 11, 2010 and the subsequent statements by the Ecofin

FT/Harris poll published on March 21, 2010, http://www.ft.com/cms/s/0/ee055e82-3529-11df-9cfb-00144feabdc0.html and the Eurogroup underline the commitment of the member governments to prevent a sovereign default in Greece. Furthermore, should the EU partners decide not to help Greece (either with or without the IMF – see options III and IV below), Athens itself could still call on the IMF (see option IV) to get financial support (even though this does not necessarily prevent a default further down the path).

From a systematic point of view, the possibility to default is the best means to make governments as responsible as possible for their own action, in particular in a currency union. However, the close economic and financial linkage between countries make the default option an implausible threat as the partners would hurt themselves as well.

The combination of these elements with the weak political governance structures overarching the single currency actually make a bail-out of some kind the more likely option for the Eurozone – unless Greece does not call on the IMF for help. The Eurozone lacks a mechanism that would enable the EMU members to let a partner down without causing chaos: there is no orderly default mechanism (and the costs of a disorderly default are simply too high).

A possible answer that can be drawn from these reflections is that the Eurozone needs its own Euro-Monetary Fund (EMF).[6] This should be set up in such a way that is does not create more moral hazard problems: an EMF should be combined with an orderly default procedure and the option to ask a member state to leave the Eurozone in order to stimulate governments more strongly to assume the outcome of their policy choices. Both the EMF and an orderly default procedure are much more important for the Eurozone than for the EU as a whole because member states lack the exchange rate as an adaptation mechanism and have given up a large part of their capacity to influence their macro-economic context.

Option II: Greece calls the IMF

The EU does not grant support to Greece. Greece decides to call in the IMF unilaterally.

The pro arguments

- The No-bail-out-clause of the Treaty would be respected.
- There would be no direct and immediate risks for the other EU governments which are all under fiscal strain.
- The risk of the Greek case provoking a loss of support for European integration in selected member states would be reduced.
- The IMF would attach clear conditionality to its loans and would act as a guardian of Greece's fiscal and structural adjustment process.

[6] See for instance: Daniel Gros/Thomas Mayer: Towards a European Monetary Fund, CEPS Policy Brief 202, February 2010, http://www.ceps.eu/book/towards-european-monetary-fund, last download March 1, 2010.

The counter arguments

- The IMF's record for overseeing adjustment processes in countries without flexible exchange rates is rather unimpressive. In Argentina, the IMF's recipes proved to be unable to stabilize the government debt trend, but only pushed the country deeper into recession which finally led to an overthrow of the government and a messy default.
- The fact that the EU lets Greece fight for itself would risk a political backlash against European integration in Greece.
- Given prior magnitudes of IMF programs, it is very unlikely that the IMF will provide a package large enough to secure all financing needs for Greece this year. The austerity program hence would have to be much harsher than the already planned one if Greece wants to avoid a default. An even stronger austerity package yet would lead to an even more protracted collapse of the Greek economy.

Assessment of obstacles, political feasibility, likelihood

There is a possibility for this scenario if the EU does not come to an agreement over the way how to help Greece. In term of financial risk, this would probably be the least costly option for the other Eurozone governments. Especially those governments that would have to shoulder the bulk of loans, transfers or guarantees to Greece, such as Germany, have come under severe public pressure. Germany in addition faces a legal constraints (see below). However, in our eyes, severe political mistakes on the side of the EU/Eurozone and its major member states would have to occur in order to provoke such an outcome. Firstly, as the IMF has fewer funds available than a joint EU/IMF package, the required austerity measures most likely would be harsher and the following collapse of the Greek economy more protracted. Not providing European support to Greece could secondly seriously hamper financial market confidence in the Eurozone, in particular if there is no move to install a crisis resolution mechanism for further cases. Moreover, the feeling of unity and solidarity among member countries would be seriously harmed.

Option III: EU rescue package without IMF

The EU opts for a solely European rescue package. This could be a mix of several elements such as bilateral transfers, loans or guarantees, EU loans, help through structural funds, etc. The EU would attach conditionality to the financial aid package but would have to implement it alone. In parallel, the existing economic and fiscal surveillance mechanisms would be applied.

For this and the following Option IV, we will not assess the arguments for or against the scenario that the EU actually jumps in, because this – in precisely the opposite logic – would mirror the arguments for and against a sovereign default of Greece listed above under Option I. In the following, the costs and benefits of the EU acting alone or in cooperation with the IMF will hence be evaluated.

Elements of such an EU rescue package could be:

- Bilateral aid: Other Eurozone countries or the EU give direct aid by cash transfers, by loans or by providing guarantees for instance through state owned banks. As a Treaty base, the so-called "solidarity clause" in Article 122 TFEU has been mentioned, although it only enables the Council to decide upon such measures "without prejudice to other Treaty provisions" (i.e. for instance the No-Bail-Out Clause of Art. 125 TFEU) and "in exceptional circumstances beyond [the governments'] control" (which would raise the question whether irresponsible fiscal policies in the last decade can be seen as beyond control of the government). While fiscal transfers are unlikely, bilateral loans combined with IMF-style conditions could indeed become an option. However, the implementation of conditionality could be a politically delicate issue.

- Help through the EU structural funds, e.g. by early releasing structural funds of which about 18,1bn. € still remain to be paid out to Greece for the 2007-2013 budget period, similar to the early help given to Central and Eastern European countries. However, Greece has a weak track record of absorbing the funds. Furthermore, the move to pay out money early without attaching further conditionality would probably increase moral hazard problems.

- The EU raises money explicitly for Greece by issuing common bonds, similar to the facility available to non-EMU members as balance of payment loans according to Article143 TFEU (former article 119 ECT). Several ECB members and the German government have rejected this approach, while the new Commissioner for Economic and Financial Affairs, Olli Rehn, has an "open mind" about it.[7] Meanwhile, issuing eurobonds for EMU members may not be compatible with the Lisbon Treaty and there would be a risk of as constitutional complaint.

The pro arguments

- Providing a European rescue package for Greece would demonstrate the political determination and ability of the Eurozone in dealing with its internal problems.
- The IMF would be kept out of the Eurozone which would not only be of symbolic value, but in the eyes of some would prevent the Fund implementing inadequate policies in the EU. Reference is made to its

[7] See http://www.euractiv.com/en/euro/almunia-backs-eu-bonds-eurozone-bailout-

weak record of action in fixed currency regimes and the fact that US-preferences, which may not necessarily be in line with continental European considerations, would influence its approach.

- If the EU's attempts work and Greece is not only prevented from sovereign default but effectively starts to tackle the underlying structural problems, this would enhance the European coordination of economic policies, probably beyond the crisis situation.
- It would increase the pressure on the EU to pursue a double strategy of immediate crisis management for Greece and the development of a framework in which real economic problems underlying the fiscal troubles in several other member states (Spain, Portugal, Ireland and Italy) could be discussed. The major problem is the divergence of competitiveness in the euro-area which is not only caused by excessive Southern European wage increases and low productivity growth alone, but also increased by policies pursue in countries with a high external surplus.
- The EU could combine its decision to put together a European rescue package for Greece with a long-term solution to similar problems: the creation of a European Monetary Fund.

The counter arguments

- The EU does not have technical Know-How and the necessary human resources in order to grant a rescue package with clear and credible conditionality and successful surveillance. In particular, the imposition of conditionality would be very difficult within the EU itself.
- The partners are politically too close and economically and financially too intertwined to build up credible pressure if reforms are not implemented to a sufficient degree. Furthermore, European political actors tend to have a bias not to point out detected problems brutally as they may be driven by EMU-image saving concerns (which was one of the reasons why the Greek problems were not tackled effectively at a much earlier date).
- Public opinion might react sensitively, both in Greece and in the supporting countries. Despite general strikes and violent demonstrations, it seems that so far there is no general public revolt against the government's reform and austerity programme. But this can come. The adaptation process that has now been launched is unpleasant due to the far reaching budgetary and structural reforms and the need to restore the rule of law. The Greek state and society will have to renounce to living beyond its means that was possible previously because it was able to rely on heavy borrowing at Eurozone low interest rates and also received substantial EU subsidies. There will be obstacles to implement reforms in the Greek administration. Public protest can also turn on external creditors imposing hard conditionality on the country. It may hence be politically useful for the EU to take along the IMF as the bad cop.

plan/article-179937, last download March 17, 2010.

- This is a strong argument against an aid-package which is predominantly based on bilateral help. If a country consortium for instance, led by Germany would try to impose conditionality on Greece, strong public and political reactions could be provoked notably with reference to the Wehrmacht occupation from 1941 to 44.
- If the "EU-only"-approach fails, the costs are potentially high. The EU will firstly have proven its inability to solve an internal problem. This would weaken the EU in the eyes of its partners politically and could cause market reactions as investors may no longer trust that EMU problems can be solved. The EU would secondly risk that emergency credit is turned into transfers - and that further transfers may be needed in order to prevent an insufficiently reformed Greece to go bankrupt at a later date.

Assessment of obstacles, political feasibility, likelihood

An EU-only approach may turn out to be perceived as less attractive than cooperation with the IMF. Especially the argument of a lack of expertise and leverage for pushing Greece into dramatic budget cuts and structural reforms seems to have clout.

The European Council's decision to take along the IMF in the March mission to Athens during which the European Commission, the ECB and the IMF will review Greece's reform progress will probably turn out to be a useful one given the additional experience by the ECB and the IMF. But the question is whether the ECB is not doing a job that is not hers if the Bank continues to fulfill surveillance functions that feed into the political decision making process of the Ecofin in implementing fiscal surveillance according to Art. 126 TFEU. Given the complexity and opaqueness of the Greek situation and the European Commission's and the Ecofin's previous problems in dealing with it under the existing surveillance procedures, taking the IMF in for surveillance and conditionality seems to be the better solution.

Option IV: EU rescue package with IMF

The IMF is called into the Eurozone in order to help sort out Greece's fiscal problems together with the EU or some member states. IMF loans could be combined with any of the European measures discussed under Option III. Both the IMF and the EU would push for a more determined structural reform agenda.

The pro arguments

- A presence of the IMF in a joint rescue package together with the EU and / or member states would bring in the necessary technical expertise and more independence which the EU does not currently have.

- The ability to impose conditionality would hence be increased if the EU cooperated with the IMF
- EU officials could be learning-by-doing while the IMF gives them basic guidance. In future situations, the EU might then not need the IMF anymore for technical expertise
- The IMF is used to taking the blame for unpopular policy measures. In Greece, it might shield the EU and Germany from people's anger. The IMF could also be used as a political scapegoat by the Greek policy makers.

The counter arguments

- In case it is found out that a fiscal adjustment alone in Greece is not feasible, the involvement of IMF money might complicate debt restructuring. The high level of government debt in Greece at the moment and the contraction of GDP which can be expected if the austerity measures are implemented, might well drive the Greek debt-to-GDP-ratio upwards to a level where it is no longer sustainable.
- In other words, it is possible that the Greek financial problems are so severe that a simple cutting of the budget deficit will not be sufficient to bring public finances back on track. In this case, a solution with debt restructuring would have to be found anyway. The IMF however, does neither have the tools to mandate nor to implement such a debt restructuring. It will even try to get its money back at the expense of other creditors and its loans will be outside the EU's jurisdictions which seriously limit the scope for action.
- The IMF's record for overseeing adjustment processes in countries without flexible exchange rates is rather unimpressive (see the remarks on the experience in Argentina under Option II).
- The IMF presence could be perceived as evidence of the Eurozone's and the EU's governance and crisis management weakness.
- Some observers say the IMF is driven by political (mainly US) interests. In the view of some, this may mean that the US may be against pressuring Greece too hard through IMF conditionality, as Greece is a Nato member and both countries cooperate in defense, there is a US military base in Crete.

Obstacles/political feasibility/likelihood

A combined action by the EU or some of its members and the IMF seems to be a reasonable scenario at the moment. Nervousness about Greece's manipulation of budget data, the use of opaque financial instruments, etc. have strengthened the perception among civil servants and policy-makers, that effective surveillance is difficult to conduct. Protests on Greece's streets, the heating up of the domestic political debate and the provocation by Greece's Deputy Prime Minister Theodoros Pangalos who accused Germany of not having paid adequate war reparations have strengthened this perception.[8] While from a Greek perspective this may have been intended as a move to put pressure on the German government to help out Greece, the effect may be precisely the opposite: German readiness to lead an EU consortium to help Greece may in fact reduce due to the new tone introduced into the debate, in particular as German public opinion is hostile against aid packages and highly critical of Greece's cheating into the EMU. An involvement of the IMF hence becomes more likely.

Conclusion

The above assessment of four arguably simplified policy options has made three things very clear: *Firstly*, there is no option which does not have relevant political, fiscal or economic costs both for the Eurozone members and Greece. *Secondly*, any choice taken on Greece will not only determine how quickly and at whose expense this particular case is solved, but also the way future cases will be dealt with. As has been argued above, a bail-out of Greece will not only increase moral hazard problems in other countries that run or risk running unsustainable fiscal policies. *Thirdly*, the strategy chosen to deal with Greece will also decisively influence the way financial market actors behave.

This signalling effect of the choice how Greece is dealt with is of particular importance with regard to the fact that other countries running unsustainable fiscal positions and face serious competitiveness problems could not be bailed out with a relatively small amount of money. Among other potentially problematic member states are Spain and Italy, which due to the size of their GDP and their overall debt and deficit volumes, would be much more difficult cases to handle. Meanwhile, the cross-border destabilising effects of a default of one of the larger EMU countries, through the banking sector, in political terms and through financial market reactions, could be much more harmful for the Eurozone.

Hence, the debate on the Greek case is and should be paralleled by a discussion of long-term solutions. The first case of a possible sovereign default in the Eurozone has revealed serious insufficiencies of the current governance set-up:

Firstly, the current economic and fiscal coordination mechanisms within the EMU are insufficient (or insufficiently applied) as they have not managed to prevent a case like the Greek one in the first place. Reflections on further developing the coordination of national economic and fiscal policies are rapidly progressing at the moment, the latest proof being a written public statement (which very rarely occurs) by the Eurogroup of March 15, 2010.[9] The declaration acknowledges that also surplus countries

[8] BBC News, Greece angers Germany in Gold Row, February 25, 2010, http://news.bbc.co.uk/2/hi/8536862.stm, last download March 1, 2010.
[9] Surveillance of intra-Euro-Area competitiveness and macroeconomic imbalances. Conclusions of the Eurogroup, March 15, 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/113375.pdf,

will have to help tackle macro-economic imbalances by identifying reforms that strengthen domestic demand. If this logic was truly implied, part of the Greek adaptation process could be driven by stronger external demand which – combined with a decisive real devaluation – may turn out to be key to put Greece on track for economic recovery and fiscal sustainability. However, political reactions from Germany following on the statement show that there is a small likelihood for a cooperative adaptation process.

Secondly, the quarrel about the question how to deal with Greece illustrates the lack of an E(M)U-internal emergency mechanism (such as for instance a European Monetary Fund), the absence of an orderly default procedure and the ultimate option to reduce moral hazard problems and make member governments more responsible for their own behaviour: the possibility to make a member state leave EMU after years of breaching jointly agreed rules and policy objectives.

These two governance debates are and should be driven forward in parallel to the question how to tackle the immediate challenges that may arise from Greece's possible calling on its E(M)U partners for emergency help.

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