

# The future of the European economy: The Greek crisis – beginning of the end of the Euro?

*MES Expert Seminar*

The Future of Europe

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# Outline

- Some recent headlines
- A chronology of events
- What's the problem with *Greece*, *PI(I)GS* and others (the UK, anyone)?
- Why did it all happen? The dark side of EU-style monetary integration
- The options: "(How) Can we fix it?"
- Outlook

## Recent headlines

- **"Risk premiums for (Greek bonds) reach record levels"** (*Börsen-Zeitung*, April 22<sup>nd</sup>)
- **"A culture of diddling"**  
(*SPIEGEL Online*, March 8<sup>th</sup>)
- **"England in distress...The next Greece?"**  
(*Wirtschaftswoche*, April 12<sup>th</sup>)
- **"Three years to save the Euro"**  
(*The Economist*, April 17<sup>th</sup> - 23<sup>rd</sup>)

# A chronology of events

- March 25<sup>th</sup>, 1998: Commission and EMI recommend NOT to admit Greece to EMU
- June 5<sup>th</sup>, 2000: Council admits Greece
- January 1<sup>st</sup>, 2001: Greece becomes EUROZONE member no. 12
- August 7<sup>th</sup>, 2002: First media reports of Greece having faked key economic data
- First half of 2004: Greek budget deficit explodes (Olympics!)

# A chronology of events

## ● Fall 2004:

- September 22<sup>nd</sup>: Greece corrects budget deficit for 2000 ex post from 2.1% to 4%
- September 23<sup>rd</sup>: Greece announces budget deficits  $> 3\%$  for every year since 2000
- November 5<sup>th</sup>: Greece pledges to take hard action to curb budget deficit
- November 29<sup>th</sup>: COMMISSION initiates excessive deficit procedures

## A chronology of events

- March 18<sup>th</sup>, 2005: EUROSTAT doubts Greek budget figures for 2005 are correct
- June 6<sup>th</sup>, 2007: COUNCIL ends excessive deficit procedures; result: Greece fully complied with Treaty provisions
- February 18<sup>th</sup>, 2009: COMMISSION reopens excessive deficit procedures against Greece (plus 5 other member states)
- October 9<sup>th</sup>, 2009: Greek central bank warns of 12% budget deficit in 2012

# A chronology of events

## ● December 2009:

- FITCH and S&P downgrade Greece's credit rating
- First mass demonstrations against austerity policy in Athens

## ● January – April 23<sup>rd</sup>, 2010:

- Political haggling over rescue package
- Mass protests continue
- EU/IMF promise € 30bn rescue package
- 2009 budget deficit corrected to 13.6%

# What's the problem with Greece, PI(I)GS...?

## ● The Greek economy:

- Accumulated gov't debt: 107% (2007)
- Average annual growth rate of gov't debt (2000-2009): 30%
- Cost of a Credit Default Swap (CDS):
  - Mid-2007: 0.15 € per 100 € of debt
  - April 2010: 4.30 €
- EU transfers received: 5% of GDP
- Average retirement age: 54 years
- Unemployment rate: 10.7%
- FAKELAKI per family per year: 1.600.- €

# What's the problem with Greece, PI(I)GS...?

## Government debt trends (in % of GDP):

(2007)      (2009)      (2020 est.)      (2050 est.)

Japan:	167%		246%	600%
Greece:	104%	115.1%	171%	
USA:	62%		133%	
Italy:	112%	115.8%	131%	
UK:	47%	68.1%	124%	400%
Ireland:	28%	64%	118%	
France:	70%	77.8%	114%	400%
Germany:	65%	73.2%	97%	300%
Sweden:	38%	42%		

# What's the problem with Greece, PI(I)GS...?

## Budget deficits (2009, in % of GDP):

–	Germany:	3.3%
–	Italy:	5.3%
–	Belgium:	6.0%
–	France:	7.5%
–	Portugal:	9.4%
–	Spain:	11.2%
–	UK:	11.5%
–	Greece:	13.6%
–	Ireland:	14.3%

# What's the problem with Greece, PI(I)GS etc...?

- Debt levels are not the heart of the problem!
- **Credibility as a debtor is, however!**
- Every year a substantial amount of gov't debt is being rolled over (refinanced)
- **Germany**: € 343 bn in 2010 (out of € 2.300 bn)
- If capital markets refuse to buy a country's bonds, (partial) sovereign default becomes a very real possibility → Argentina 2004!
- **Average since 1800: Countries representing 2%-10% of global GDP are (partially) insolvent**

# What's the problem with Greece, PI(I)GS etc...?

- Greece = 2.7% of the EU's GDP
- Germany = 27% of the EU's GDP
- Key problem: Greek/PI(I)GS' default = contagion:
  - German banks are big PI(I)GS creditors:
    - € 15-30 bn (to Greece only)
    - € 226 bn (to Greece, Spain, Portugal)
  - High exposure of other EU lenders, too:
    - € 216 bn (from French banks)
    - € 326 bn (from other Euro area lenders)
    - € 107 bn (from UK banks)

# What's the problem with Greece, PI(I)GS etc...?

- Worst-case scenario in a nutshell:
  - Governments worldwide have (committed to) spent US\$ 5,000bn (so far!) to save the global financial system
  - Overall, banks still have negative equity, i.e. the banking system as a whole is insolvent
  - Weak (German and EU) banks are main creditors of Greece/PI(I)GS
  - (Partial) Default of Greece/PI(I)GS = enormous insolvency risk for German and EU banks
  - Next round of bailouts would be inevitable!

# Why did it happen? The dark side of EU-style monetary integration

- Monetary Union = special case of fixed exch. rates
- Participants sacrifice two key policy instruments
  - **Monetary policy** (interest rates; inflation)
  - **Exchange rate policy** (re-/devaluations)
- Other mechanisms must take their place!
- Otherwise: Costs of monetary integration > benefits
- Which countries should form a monetary union?
  - **Theory of optimum currency areas**
  - **EU: Convergence (Maastricht) criteria**

# Why did it happen? The dark side of EU-style monetary integration

- Prerequisites for a successful monetary integration according to theory of optimum currency areas:
  - High mobility of labour and capital
  - High degree of price and wage flexibility
  - Similar business cycles
  - Homogeneous preferences (inflation rate!)
  - Interregional risk-sharing mechanism (= automatic fiscal transfer system)

# Why did it happen? The dark side of EU-style monetary integration

- Prerequisites according to the Maastricht criteria:
  - Similar inflation rates
  - Similar long-term interest rates
  - Stable exchange rate and two-year membership in ERM II
  - No excessive deficits
    - Annual budget deficit
    - Accumulated government debt

# Why did it happen? The dark side of EU-style monetary integration

- History shows that lack of convergence destroys:
  - Monetary unions
  - Systems of fixed or pegged exchange rates (e.g. Bretton Woods, ERM I, Asian crisis)
- Maastricht myth: "It can't happen here"
- Maastricht approach: three lines of defence
  - Convergence criteria
  - Stability and growth pact
  - No-bailout clause (Art. 125 TFEU)

# Why did it happen? The dark side of EU-style monetary integration

- **Myth vs. reality of EU monetary integration:**
  - **ERM effectively collapsed in 1992/93 crisis**
    - Old corridor: +/- 2.25% (+/- 6% for Italy)
    - New corridor: +/- 15% (!)
  - **Maastricht criteria: not strictly enforced**
    - Maximum of 3-4 EU members were "fit"
    - 11 were considered "fit" and admitted
    - Lacking: balance of payments criterion
  - **Stability and growth pact: never enforced**
  - **No-bailout clause: very unlikely to be enforced!**

# Why did it happen? The dark side of EU-style monetary integration

- Unintended side-effect of large-scale EURO adoption in 1999-2002:
  - Typically, long-term interest rates reflect market expectations of a country's future inflation and default risk
  - Before EURO: large differences between high-inflation and low-inflation member states
  - After EURO: fast convergence toward the much lower German (Dutch etc.) levels
  - Negative real interest rates → credit/debt grow to unsustainably high levels (artificial boom!)

# The options: "(How) Can we fix it?"

- EU monetary integration – myth vs. reality:
  - **ERM I effectively collapsed in 1992/93 crisis**
    - Old corridor: +/- 2.25% (+/- 6% for Italy)
    - New corridor: +/- 15% (!)
  - **Maastricht criteria: not strictly enforced**
    - Maximum of 3-4 EU members were "fit"
    - 11 were admitted (Greece one year later)
    - Lacking: balance of payments criterion
  - **Stability and growth pact: never enforced**
  - **No-bailout clause: very unlikely to be enforced!**

# The options: "(How) Can we fix it?"

## ● What options does Greece have?

- **Full or partial sovereign debt default → NO!**
  - Politically unacceptable for Greece and EU
  - Potentially huge contagion effects
- **Inflation → impossible without national currency**
- **Leave EUROZONE → NO!**
  - Economic suicide!
  - Massive devaluation increases debt burden
- **Radical structural reforms → NO!**
  - Political suicide for every Greek Prime Minister

# The options: "(How) Can we fix it?"

- What options does the EU have?
  - Political and economic pressure → very unlikely!
    - Enforcement track record unimpressive
    - Tit-for-tat opportunities in other policy areas depending on decision-making rules
  - Bailout → most likely outcome
    - Demonstration of EU solidarity!
    - Other people's money!
  - But: Permanent bailout extremely likely!
    - Precedent: Germany → HB, Berlin, Saare

# Outlook

## ● Short-term view:

- Greece will be (permanently) bailed out!
- T.I.N.A. → There is no (political) alternative

## ● Mid-term/Long-term view:

- Sets dangerous precedent → moral hazard!
- Unfair! Many member states have undergone or are undergoing painful structural reforms
  - CEE accession countries
  - Germany ("sick man of Europe" 2000ff.)
  - Ireland (2008ff.)
- EUROZONE North vs. EUROZONE South?

**THANK YOU  
FOR YOUR ATTENTION!**

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