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Greece and the Euro Crisis

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During the first two decades after the fall of the dictatorship in the early seventies, Greece's economy displayed weak performance: low rates of growth, large fiscal deficits, double-digit inflation and interest rates, unstable currency. The accession into the Eurozone created new conditions leading to the stabilization of the economy and the acceleration of growth. The deficit fell from 12% of GDP in 1993 to 3% in 1999, the inflation rate fell from 14 ½% to 2 ½ % while the growth rate rose from an average 1 ½% to close to 4% in 1997 and stayed at this level until 2008.

Eurozone - related growth was fuelled by the increased confidence gained by consumers and investors alike through the securing of stability conditions and lower real interest rates. Thanks to structural reforms, in particular privatizations and market liberalization, as well as the modernization of infrastructure, production responded positively to the growth of demand. Eventually, however, reforms stalled while laxity, inaction and clientelism gradually prevailed as dominant features of governance. Competitiveness weakened leading to a widening external deficit and a sharply upward trend in private and public borrowing. The country started to live above its economic potential.

A.Samaras, President of New Democracy, the party that was in power from 2004 to 2009, was very candid, in a recent speech, about the failings of the government in that period:

"Our government made mistakes. Serious mistakes. It did not fight statism. It did not reinstitute the state. It increased, rather than diminish, the size of the state. It preserved its dysfunctional and unproductive character. It succumbed to the logic of political cost. For all these we must apologize to those who voted for us, to the Greek people".

Greece is now facing an acute fiscal crisis with borrowing costs rising to record levels. The deficit reached 12.7% of GDP in 2009 while the public debt is expected to exceed 120% of GDP this year. The present government is addressing the problem in a determined way. It has taken measures, including deep cuts in public sector wages and substantial increases in value-added and excise taxes, aiming at a reduction of the fiscal deficit by 4% of GDP in 2010. It is fighting tax evasion and promoting efforts to eliminate waste and streamline public administration. It is planning to introduce a major reform of the Social Security system so as to sustain its long-term viability.

It is also laying out a new strategy for economic recovery based on the transition to a knowledge economy as well as on green growth. Privatizations and market liberalization, involving the abolition of closed professions, bringing down barriers to competition and eliminating excessive bureaucracy, are crucial for helping business contribute to preventing a prolonged recession as well as boosting productivity.

Despite, however, these policies, markets continued to doubt Greece's ability to surmount her fiscal problems and set the economy back to a course of sustained growth. The persistence of excessively high rates for borrowing raised, inevitably, the question of external economic assistance and, eventually, of a bail-out mechanism.

The Greek crisis revealed cracks in the Eurozone. In a national state there are unified authorities for monetary and fiscal policies as well as for the supervision of the financial system. In the Eurozone a unified authority exists only in the monetary field. It is the European Central Bank (ECB). Fiscal policy and the supervision of the financial system belong to the jurisdiction of national states.

The absence of a central supervisory authority for the financial system created doubts as to the ability of the weaker member-countries to bail out their banks. Credit risks spread sharply so that overindebted countries started to borrow at much higher interest rates in relation to Germany. This tendency, reinforced by negative ratings by international agencies, may lead to credit crunches, even to default.

The crisis has highlighted the fact that the euro is a monetary union but not a political union. It does possess a central bank, but not a Treasury. The central bank can provide liquidity in times of crisis, though only a Treasury can address problems of solvency.

These weaknesses were exposed. Greece is a policy failure, as California was in the context of the United States. California's fiscal crisis, however, did not destabilize the dollar because the federal system contains mechanisms combining assistance with sanctions so as to either prevent or manage default, and thus ensure financial stability.

The absence of such mechanisms within the Eurozone, underlined by the "no bail-out" clause of the Treaty, makes the euro, as well as the sovereign debt of its constituent parts, inviting targets for speculative attacks. Markets take bets on the endurance of the system.

The risk of policy failure in a monetary union is as real as failure in any market system. Ignoring it offers no solution. The alternatives imply either recourse to an external bail-out mechanism, that is, the International Monetary Fund (IMF) undermining thus the integrity of the euro, or thinking the unthinkable – exit from the Eurozone.

For the time being, in order to address the Greek problem an *ad hoc* mechanism of assistance has been devised, involving the IMF and bilateral Eurozone loans coordinated by the ECB and the European Commission. Greece has requested last week the activation of this mechanism. Negotiations have already started.

Within the Eurozone, discussion has already started for longer-term arrangements aiming at improving economic governance. The issues involved include the reinforcement of the Eurogroup's fiscal authority, the issuance of Eurobonds and the creation of a European Monetary Fund.

Stronger coordination of fiscal policies is essential for preventing diverging behaviour on the part of the member-countries of the Eurozone. Reinforcing the authority of the Eurogroup and the ECOFIN Council will improve the effectiveness of fiscal policy, particularly as regards meeting targets as well as redressing imbalances. Germany's model, consisting in relying on export growth while constraining internal demand, has been heavily criticized recently. Germany's surplus is mirrored in other countries' deficits. And, when private demand is weak as is presently the case, external deficits are translated into fiscal deficits leading to credit crises.

Common budget policies and rigorous supervision of their implementation are a *sine qua non* condition for the efficient functioning of the Eurozone. They will also create a more balanced framework of cooperation with the ECB. Fiscal and monetary policies must function in better harmony in relation to the current situation so that the targets for growth, employment and inflation are more effectively pursued.

The issuance of Eurobonds covering the whole of the Eurozone could help relieve the pressure emanating from credit crises. Such bonds, however, are viewed with suspicion by Germany, which is reluctant to finance overindebted partners. A compensation mechanism imposing a corresponding charge on the weaker economies could help remove Germany's reservations while serving her long-term interest in sustaining the stability and credibility of the common currency.

A more radical solution to the bail-out problem for failing economies would be the creation of a European Monetary Fund along the lines of the IMF. This fund could extend low-interest loans tied to strict conditionality ensuring the return of the deviant countries to fiscal balance and financial stability.

Unless the Eurozone develops procedures designed to transform it into a fully-fledged economic union, approaching the US model, the future of the euro will be clouded with doubt. Without strong institutions in the fiscal and financial field, the Eurozone will essentially remain a club of countries willing to adhere to certain principles of economic policy, such as price stability and fiscal discipline. Experience, however, suggests that voluntary adherence to principles does not stand the test of time. Deviance is a risk inherent in the life of any system. And if deviance is neither prevented nor controlled, the system faces the risk of dissolution.

It is, therefore, critical for the Eurozone to strengthen its system of governance. The effective conduct of economic policy in the USA contributes to the achievement of substantially higher rates of economic growth compared to the Eurozone. This, quite apart from the risks of break-up or dissolution, should suffice for mobilizing energies in Europe to speed up the integration process.