Spotlight falls on Greece

As its weakest member state slid towards bankruptcy earlier this year, the future of the eurozone appeared in doubt. In a revealing account, *Tony Barber* charts the events that led to one of the biggest rescues in history

In the news: George Papandreou, Greek prime minister, speaks outside the White House in Washington, DC, in March this year

PHOTO: EYEVINE

IN EUROPE'S CAPITALS, they still talk of the evening when George Papandreou, the Greek prime minister, confessed to his fellow leaders that his nation was corrupt. "He was very impressive and very honest. He basically said, 'My country is a corrupt country from A to Z,'" recalls one EU policymaker who was present at the dinner in Brussels on December 10 2009 where Papandreou bared Athens' economic soul.

His admissions at the start of that summit were an essential step in the process by which, in May 2010, Greece's partners (persuaded that the prime minister was sincere about introducing fundamental reforms) came to announce a €110bn ($150bn) rescue of the eurozone's most financially rotten state. Yet contrary to the impression they gave at the time, EU policymakers had known months before Papandreou took office in October 2009 that Greek public finances were in the most dire straits.

In July last year, Joaquín Almunia, a Spanish socialist and the EU's monetary affairs commissioner, circulated a memorandum to European finance ministers expressing strong doubts about the reliability of the data the Greek government at the time was supplying to Brussels. The document even predicted that the budget deficit was likely to soar above 10 per cent of gross domestic product – a forecast Papandreou's socialists confirmed soon after they came to power in October. Yet EU governments took no action before then, perhaps because, in time-honoured fashion, they deemed it inappropriate to embarrass a fellow government, especially one facing a hard election campaign.

If this episode reveals much about the manner in which political considerations interfere with the efficient management of Europe's monetary union, so too does the sorry tale of the stability and growth pact. These fiscal rules, agreed in 1997 after many bruising discussions between Germany and France, set a ceiling for countries aspiring to adopt the euro of 60 per cent of GDP for public debt, and 3 per cent for budget deficits.

All along, German policymakers suspected that once countries had qualified for membership, their commitment to budgetary discipline would falter. So it proved – though few would have anticipated that Germany itself would be among the first offenders.

"The Germans were worried that the culture of fiscal laxity in other countries wouldn't change overnight. They thought that what was needed was a sort of straitjacket. It turned out to be not very straight and not much of a jacket," jokes Pascal Lamy, the French director-general of the World Trade Organisation, who served as chief of staff to Jacques Delors, the European Commission's president, from 1985 to 1995.

> "The aftermath of the financial crisis is set to bring a simmering fiscal problem to boiling point"

The financial crisis and recession of 2008-09 threw EU public finances into disarray, forcing governments to spend hundreds of billions of euros on recapitalising financial sectors and fiscal stimuli to protect jobs. But these costs are dwarfed by the potential impact of state support for Europe's ageing societies.

A European Commission report warned last November that the continent faced "unbearable increases in debt interest and pension expenditure, as well as in healthcare and long-term care during the coming decades" unless "ambitious efforts" were made to consolidate government accounts and enact structural reforms. Otherwise public debt for the 27-nation EU as a whole could soar by 2014 to 100 per cent of GDP – equivalent to a year's economic output – and continue to rise thereafter.

The essence of the problem is that the ratio of the elderly to the working population is set to increase sharply, given low birth rates and people living longer. The rise is expected to be especially pronounced in countries such as Greece and Italy, already burdened with public debts in excess of 100 per cent of GDP. But the budget projections of most EU governments do not reflect the full cost of ever-higher pensions and healthcare bills.

In a report for the Bank for International Settlements, economists M.S. Mohanty, Stephen Cecchetti and Fabrizio Zampolli observed: "The aftermath of the financial crisis is poised to bring a simmering fiscal problem in industrial economies to

boiling point." The challenge will look more daunting once interest rates, exceptionally low because of the financial crisis, begin to rise again.

Small wonder, then, that Germany, Greece, Ireland, Portugal and other eurozone states have embarked on the arduous task of pension reform. The country to watch, though, is France.

Nicolas Sarkozy, the centre-right president, is battling public sector protesters to lift the minimum retirement age from 60 to 62. This may seem unambitious, but the context is all-important: ever since the leftist Popular Front government of 1936, France has prided itself on reducing the amount of time people work. This tradition may soon be at an end.

Alarm bells rang in 2002 when the European Commission proposed that Germany and Portugal be sent an "early warning" by fellow governments that their deficits were fast approaching the 3 per cent limit. Governments ignored the commission's suggestion.

The commission tried again in 2003, requesting that France and Germany take stiffer deficit-cutting measures. But at a momentous meeting on November 25 that year, finance ministers suspended the excessive deficit procedure against Paris and Berlin, a decision that let the eurozone's biggest countries off the hook even though they had broken the rules for three consecutive years. It was notable that, while Italy and the UK sided with France and Germany, most smaller states supported the commission. The split suggested that the big fish thought there was one rule for them and another for the minnows.

By March 2005, EU policymakers had substantially rewritten the stability and growth pact, loosening its rules and making it even less likely that any country would be punished for excessive deficits. The reaction of the financial markets was mild, which perhaps let some governments feel they had got away with it. In the eyes of some, this set a disastrous precedent.

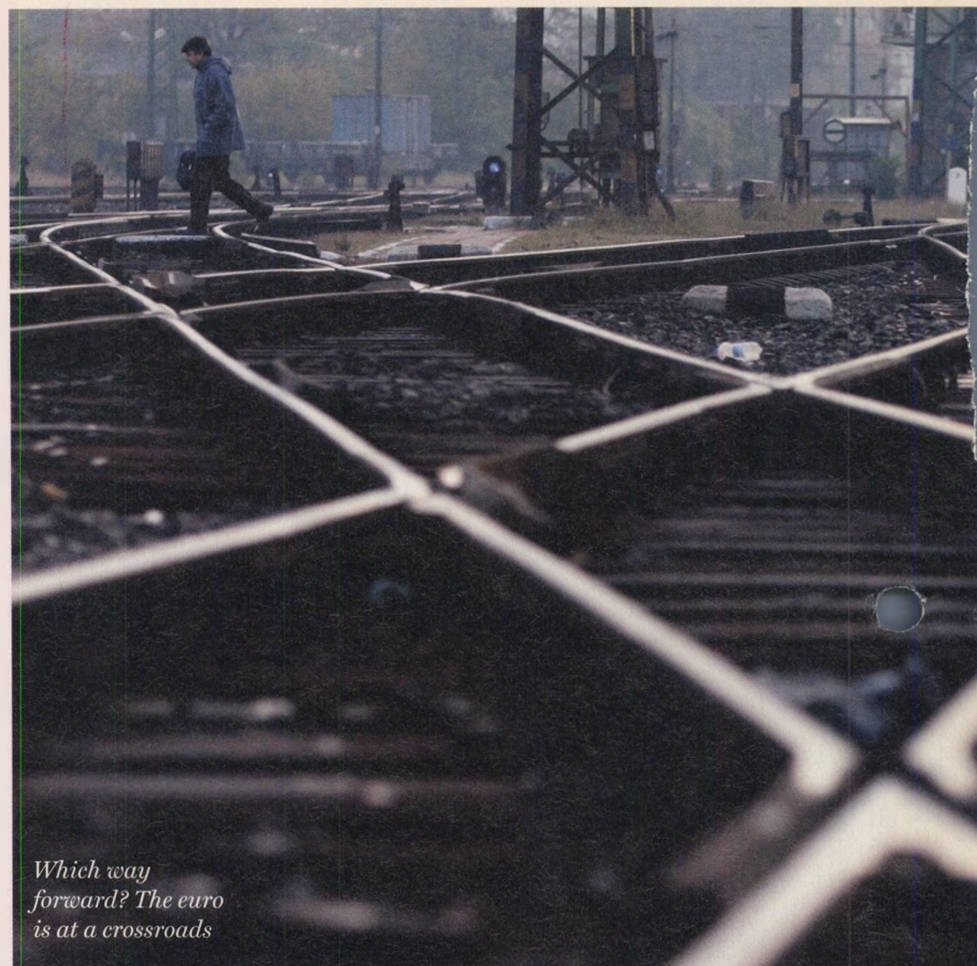
"This was the first serious mistake in the euro area because it opened the door for other countries to make excuses and point at Germany and say, 'Look, they did it, so leave us alone!'" recalls Jürgen Thumann, president of BusinessEurope, the pan-European employers' association.

The WTD's Lamy concurs. "It was a real mistake. The instrument of credibility was destroyed. The Germans would have liked a stronger stability pact, but it's not only a question of what such a pact says – it's about how the rules are implemented."

The chances that governments would be more inclined to obey the rules did not exactly brighten when Romano Prodi, president of the European Commission from 1999 to 2004, asserted in October 2002 that the pact was "stupid" because it provided for sanctions on countries that were already in financial difficulties. "He's an honest man, dedicated to European integration – his heart is in the right place. But we felt straightaway that he shouldn't have said that," says one former commissioner.

In the light of this year's fiscal rescue of Greece, some eminent Europeans – such as John Bruton, the former Irish premier, and Karl Otto Pöhl, the former German central bank president – say it is surprising, if not outright shocking, that the country was allowed to join the eurozone in the first place. Their argument is buttressed by the fact that, less than four years after Greece's entry in 2001, the authorities in Athens acknowledged that they had misreported the public finances data they had supplied to ensure qualification. Contrary to what they had claimed, the budget deficit had been consistently above 3 per cent in the run-up to entry. Indeed, since 1990, the deficit has fallen below 3 per cent in one year only.

Former commissioners say the data were widely known at the time to be unreliable. "Back then, I don't know if you could even count on an accurate Greek statistic about the number of kilometres from Marathon to Athens," recalls Chris Patten, the UK Conservative who served as EU commissioner for external relations. "It was a case of, 'We all pretend to believe them, and they all pretend to be doing enough for us to believe them.'"



Which way forward? The euro is at a crossroads

PHOTO: REUTERS

HOWEVER, FEW IF ANY EU governments objected to Greece joining the single currency. One reason was that policymakers needed it to extend beyond a "hard-core" D-Mark zone of Germany and its nearest five or six neighbours to present monetary union as an authentically European project.

A proposal for a "hard-core" monetary union had, in fact, been put forward in 1994 by two German Christian Democrats – one of them, Wolfgang Schäuble, is now German's finance minister. But the idea never got off the ground. Countries geographically distant from Germany, such as Greece, Ireland and Portugal – the very nations now most at risk in the eurozone debt crisis – got in. Once again, political requirements trumped economic realities.

Lamy describes how the debate evolved. "The Greek numbers may not have been totally straight and there had also been rumours before about the Italian numbers, but this was about politics, not just numbers.

"It was about addressing the Club Med complex and challenging the notion that these guys around the south and in the Mediterranean are not really serious."

Both Prodi and José Manuel Barroso, his successor as president of the European Commission, say EU governments bear much of the blame for the failure to crack down on Greece because they refused to grant the union's statistics agency, Eurostat, the right to audit national accounts. Governments belatedly strengthened Eurostat's powers in July.

The tensions that built up between 1999 and 2009 were not, however, just the result of structural flaws in the design of monetary union, nor of economic mismanagement on the part of eurozone governments; they reflected misjudgments in financial markets, too. With the advent of the euro, markets all but eliminated interest rate differentials between German government bonds and those of other eurozone countries with far less respectable economic records – notably Greece.

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EUROZONE MILESTONES

1991 European leaders sign the Maastricht Treaty, setting out the path to monetary union by 1999
1997 Governments conclude the stability and growth pact, the fiscal rule book for the eurozone
1999 Eleven countries adopt the euro – the number rises to 16 by the time of the 2010 debt crisis
2001 Greece joins the eurozone
2003 France and Germany join forces to avoid punishment under the stability and growth pact
2010 Greece receives a €110bn ($150bn) EU/IMF rescue

In one sense, this should have pleased European policymakers, as it demonstrated the faith of investors in financial centres such as London and New York – occasionally scolded by continental European policymakers for questioning the single currency's viability – that the eurozone was an indissoluble unit. But once the scale of Greece's troubles became clear, markets rushed in the other direction, and bond yield spreads for Greece and other "peripheral" eurozone countries, such as Ireland, Spain and Portugal, soared to record levels.

For Lorenzo Bini Smaghi, the Italian member of the European Central Bank's executive board, this offers an important lesson for the eurozone's future: markets are not always right. They "were wrong in the past in underpricing risk, are probably wrong at present in overpricing it, and will again be wrong in the future", he announced to the European Parliament in September.

But markets can hardly be blamed for the dangerous imbalances that arose in the first 10 years of monetary union: between highly competitive countries with big current account surpluses, principally Germany, and the likes of Greece, Portugal and Spain which lost competitiveness, ran up large deficits and borrowed too much. Some economists doubt the eurozone can survive in its present form unless Germany helps correct these imbalances, for example by raising domestic demand to boost growth in southern Europe and accepting a degree of fiscal union.

SUCH ARGUMENTS – WHICH are particularly fashionable in Paris – are hotly disputed in Berlin, where policymakers say Germany answered its critics by launching a big fiscal stimulus package in response to the recession. Moreover, Germany, with its generous welfare state and ageing population, regards its trade surpluses as a means of strengthening its financial defences against the future. In any case, if the ruling centre-right coalition were to take the step of making the country's businesses less internationally competitive, would Germans really buy more goods from France and its southern European allies?

Germany has supporters in this debate – Austria, the Netherlands, Finland, Slovakia and Slovenia, to name but five. But Germans fret that the eurozone – its membership will rise to 17 when Estonia joins in January – contains a structural majority sympathetic to France's views. This explains Berlin's determination not to fall for a siren song of European unity that disguises the more cunning proposition that it should pick up the bill for its less efficient partners.

Katinka Barysch, deputy director of the Centre for European Reform think-tank, contends that the Germans are in no mood to compromise. "Perhaps for the first time since the second world war, they are allowing themselves to be defiant and proud. Their export-orientated, stability-obsessed economic model is not up for discussion." ■

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