EMU and the Greek crisis: Are there lessons to be learnt?*

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Abstract

We describe the political-economic environment that precipitated the Greek crisis. Involved were nocuous collaborations between private interests and the formally appointed custodians of the public interest, and a captured politicized bureaucracy. The confluence of these forces aided in the pilfering of public funds, allowed rampant tax evasion, and sanctioned the deterioration in the quality of publicly provided goods. From a macroeconomic perspective, the failure of successive Greek governments to reverse the decline in the national saving rate, and not the government budget deficit *per se*, is the main reason for the crisis. The inability of EMU authorities to react to portents of Greek failure, such as ongoing large current account deficits that were not hidden by "Greek statistics", expose a major fault line in the EMU's design and implementation through the Stability and Growth Pact.

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1. Introduction

The metastasis of the Greek crisis from a peripheral incident involving a fiscally irresponsible government to a systemic crisis threatening the euro was for many a surprise. The announcement by the newly elected Greek government in October 2009 that the projected budget deficit for 2009 was 12.7% of GDP[1] (rather than the 5.1 percent projection appearing in the 2009 Spring Commission forecast) was initially met with shock and opprobrium in Brussels and other euro area capitals. The opprobrium may well be what Greece deserved. The "shock" (especially expressed by EU officials) was not due to the economic significance of the situation but rather was due to the fact that a Greek government had lied to its euro area partners. Although one can have doubts about how truly "shocking" were the revelations of the Greek authorities for the EU officials,[1] the key issue is that the systemic implications of the revelations were ignored – the fears of contagion were underplayed and the prevailing feeling was that the correct way to deal with the situation was to let Greece "swing in the wind".

Nevertheless, by early May 2010 the contagion from the Greek crisis was spreading across Europe, evidenced by the widening euro area sovereign CDS and bond yield spreads relative to German bunds, the fall in equity markets and in the euro against major currencies (BIS, 2010). The Irish, Portuguese, and Spanish repo bond markets were becoming less liquid, and market participants started paying closer attention to the exposure of different banks to Greek, Portuguese, or Spanish sovereign debt. By this time, policymakers had recognized the gravity of the situation, and in addition to the €110 billion bailout package offered to Greece by the EU/ECB/IMF, they decided on May 10 to set up a €750 billion rescue package in an effort to prevent a eurozone confidence crisis.[2] The ECB provided further support through its decision to buy euro area bonds in the secondary markets. However, despite the unprecedented size of the rescue packages, market participants were unconvinced that the crisis would not spread further. There was fear that what started as a Greek sovereign debt crisis would morph into a banking crisis due to the interconnections among the national banking systems in Europe (BIS, 2010).

Lest a reader think otherwise, we hasten to add that this essay in no way is an effort of two Greek economists to exonerate their country from grave errors. Indeed, we believe that, even before the global economic crisis arrived, Greece was a disaster waiting to happen – the crisis just brought the day of reckoning closer (see Moutos and Tsitsikas, 2010). Nevertheless, we argue that, beyond the imprudence displayed by successive Greek governments, the EMU and the attendant Stability and Growth

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[1] It turned out to be even higher than that; the still provisional figure, as announced by Eurostat in April 2010, was 13.6% of GDP.

[1] It is difficult to avoid the temptation and not draw an analogy with the behavior of Captain Renault in the film Casablanca. Captain Renault is admonishing Rick (the owner of the café) with the words " I'm shocked, shocked to find that gambling is going on in here" at the same time as a croupier hands Renault a pile of money with the words "Your winnings, sir", which he readily accepts.

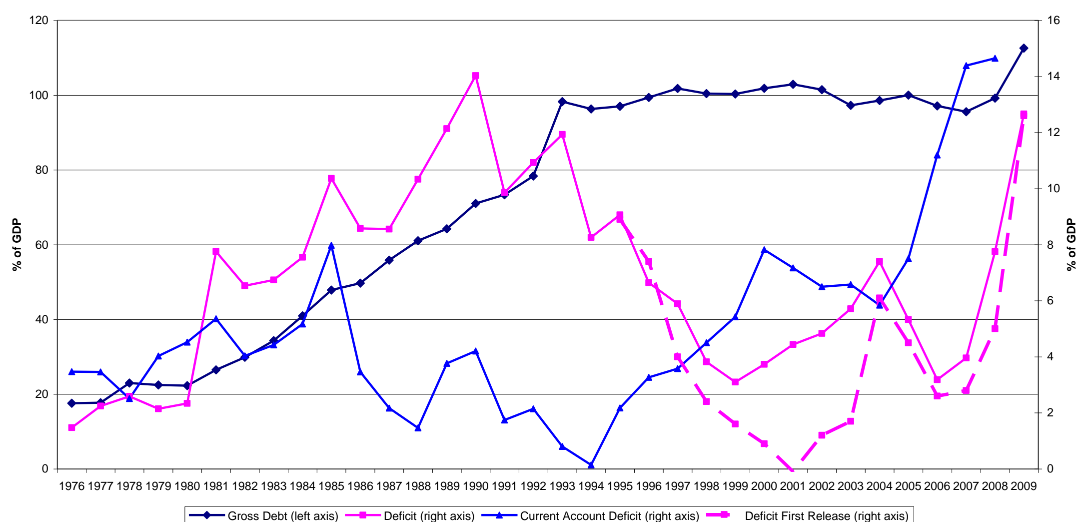
[2] As one may expect in such cases, our interpretation of events is not without dispute. Indeed, a referee stated that "… a significant part of the profession would probably state that the consequences of contagion were *overplayed* during Spring suggesting that indeed it would have been better to let Greece swing in the wind throughout…many would state that European policymakers overstated the international consequences and *overreacted* and in that way actual made the Greek problem into a European problem".

Pact (SGP) were imprudently designed in being based on the supposition that the main threat to the EMU is irresponsible behavior by member-state governments only; the undesirable consequences of excessive borrowing and lending by private units driven by moral hazard and deficient corporate governance were ignored.

2. Greek political economy and the crisis

The Greek economy entered the second phase of the pre-EMU accession period in 1994 with both a large public debt and a large budget deficit, and went through a reduction of 9 percentage points (of GDP) in its budget deficit between 1993 and 1999 in order to be admitted to the euro area.[3] Unfortunately, these efforts were to a large extent abandoned in the subsequent years. This was because in the pre-EMU accession phase, the threat of exclusion acted as a hard budget constraint that forced the Greek government to redress its fiscal imbalances. In contrast to the output-driven, “hard-conditionality” of the pre-accession period, the EMU period was characterized by the “soft-conditionality” of the SGP, which allowed Greece (even more than other governments) to breach both the letter and the spirit of the Pact (von Hagen, 2005). In fact, as shown in Figure 1, for all 9 years between 2000 and 2008 Greece violated in every year the 3% limit on budget deficits. What is also of interest is the relationship between the first release of the budget deficit and the current vintage of the budget deficits (the ones showing that Greece violated the 3 percent limit in every year). The dotted line in Figure 1 (starting in 1995) depicts the first release of the budget deficit (% of GDP) for year *t* notified by Greece to Eurostat in March/April of year *t+1*. (An important revision of deficit and debt data was undertaken in 2004; see Eurostat (2004) and European Commission (2010).) It is these large differences between the first releases and the current vintage of budget deficits that have compromised the credibility of Greece as a reliable partner in European affairs.

Figure 1: *Greek Government Debt and Deficits.*



Source: Ameco, European Commission, OECD, IMF

[3] The formal announcement regarding Greece’s admission into EMU was made during the European Council in June 2000.

An important drawback of Maastricht criteria (relevant for EMU entry) was their focus on numerical targets without paying attention to the *modality* or quality of fiscal adjustment. It has been argued that fiscal adjustments that rely too heavily on increasing tax revenue rather than on cutting government spending are less likely to be successful and sustainable (e.g., Perotti et al., 1998). A reason for this is that, for the consolidation to be successful, it must deal forcefully not only with politically sensitive spending items such as transfers and public sector wages, but it must also stop the hidden (legal or otherwise) subsidies given to inefficient but politically-connected firms that stifle the creation of new and productive firms.

The Greek experience confirms the ephemeral nature of adjustments that rely excessively on tax increases. From 1993 to 2000, the share of tax revenue in GDP increased by about 8 percentage points whereas the share of government spending remained intact. During the soft conditionality of the EMU, and until the global crisis started to affect Greece in 2008, total government spending kept fluctuating between 43 and 45 percent of GDP, whereas tax revenue appeared to be on a declining trend (from 42.9% in 2000 to 39.6% in 2007). However, what is more revealing (Figure 2) is that government spending excluding debt interest payments was *rising* during the pre-EMU period, since interest payments were steadily declining as a result of nominal convergence to the rest of the euro-area countries. (The decline in debt interest payments after EMU was considered by the Greek governments as a permanent windfall – due to their thinking that there is an implicit guarantee of a no-strings-attached bailout by the rest of euro area in case of problem - a miscalculation that most Greeks have come to regret.) In contrast, the other eurozone countries followed on average exactly the opposite strategy of a distinct decline in government expenditure while tax revenue remained almost constant. We note that these different approaches to budget consolidation can only partly be explained by initial (1995) differences in revenue shares between Greece and the eurozone countries; if the increase in taxation in Greece was a conscious effort to emulate the taxation patterns of other eurozone countries, we would not have observed the large subsequent (post-2000) decline in taxation in Greece.

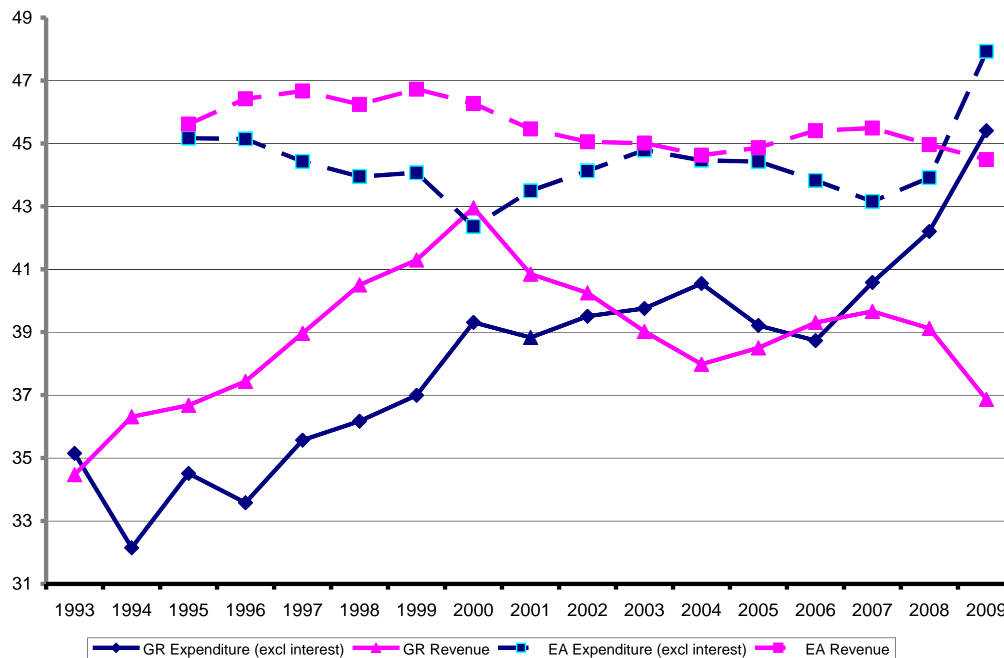
The unwillingness of Greek policymakers to undertake expenditure cuts reflects the lower political cost of raising tax revenue compared to expenditure cuts. This has occurred for various reasons. First, the increase in revenue was mainly achieved through increases in indirect taxation, which is considered less 'visible' to voters compared to direct taxation and so is a source of fiscal illusion. Second, although the cost of an increase in taxation is spread among voters/consumers, the political cost of expenditure cuts mainly affect the constituency of the party in power, since a large proportion of government expenditure is targeted towards specific interest groups (e.g., public employment).[4] Third, given that in Greece rent seeking[5] and tax evasion

[4] This issue could be particularly acute in the case of local governments. However, the Greek government is highly centralized. Central government collected almost 67% of revenues and accounted for about 55% of expenditures in 2007; the corresponding figures for the OECD average are 58% and 43%, respectively (OECD, 2009c). Local governments represent a very small portion of total revenues and expenditures (Greece: 2.6% and 5.6%; OECD: 17.6% and 32.2%, respectively).

[5] Angelopoulos et al. (2009) provide estimates of the social costs of rent seeking. They find that Greece exhibits the highest rent extraction and rent seeking among EU countries, with about 53% of tax revenue extracted by rent seekers.

are endemic,[6] the beneficiaries of these practices have used their political power to minimize the reduction in public spending (their main source of pilfering) and shift the burden of budget consolidation to increases in taxation (that they are adept at avoiding or evading).

Figure 2: *Expenditure (excluding Interest) and Revenue of General Government - % GDP*



Source: Ameco.

But why did the restoration of democracy in 1974 fail to reduce the outright corruption, nepotism and tax evasion that have characterized modern Greece? Why have EEC accession (as the EU was called in 1981) and attempts at "modernization" failed to create a well functioning democracy? The dismantling of repressive political mechanisms after 1974 meant that governments had to rely on social and economic policy measures in order to garner political support.[7] The growing societal demands, along with the willingness of the then conservative governments to appease an

[6] According to OECD (2009a), the efficiency of tax collection in Greece in 2006 was the lowest among the eurozone countries; with respect to VAT, tax collection in Greece was only 75% of the unweighted average for the eurozone countries, and for social security contributions and corporate taxes 87% and 75%, respectively, of the eurozone average. Assuming that the relative efficiency with respect to all other sources of tax revenue (including income taxes) was as high as 87% of the eurozone average, we can calculate the likely effect – ceteris paribus – on tax revenue if the efficiency of tax collection in Greece were equal to the EU average. Using pre-2008 data for the different categories of tax revenue in Greece, we find that such an increase in tax collection efficiency would have resulted in extra tax revenue of about 5% of GDP, thus turning the budget into surplus for most of the years. Raising tax collection efficiency to the average level of Italy (the second worst country in terms of tax collection efficiency in the eurozone) would have raised tax revenue by about 2% of GDP.

[7] A reasonable objection to this argument is that the dismantling of repressive mechanisms creates goodwill and political support without the need for general state handouts. However, it must be noted that in Greece, both before, but mainly during the junta, the repressive mechanisms were used in order to compress the expression of trade union wage aspirations as well as societal demands for expansion in the provision of public goods. The restoration of democracy meant that political parties had to acquiesce to the latent demands of a large part of the electorate – see Rodrik (1998) for international evidence on the positive effect of democratic regimes on wages.

electorate that was all too eager to resume the radicalism of the 1960s, led to a transfer of systemic power from the state to society, or rather, from a moderately-effective state bureaucracy (the semblance of a *strong state* in the Weberian tradition) to groups that claimed to better represent society's interests (Pagoulatos, 2003). The growing influence of trade unions and employer associations, in combination with the excessive politicization and weakening of the autonomy of the bureaucratic apparatus after 1974 (and especially after 1981), paved the way for the gradual transformation of the Greek state administration from an almost "developmental state" to an "intermediate state".[8] During this period the older individualistic (or family-based) system of patron-client relationships was supplemented by one dependent on favors bestowed on party members by the party machine (Charalambis, 1989).

The capture of the public administration by the political parties was cemented by the fragmentation of the unions representing public-sector workers along party-political lines, and by their overwhelming influence on personnel choice and promotion to potentially lucrative posts. In effect, this meant that able civil servants had to "take sides" and "declare their allegiance" with a particular political party if they wanted to avoid being left behind in their careers or to avoid punishment for any unlawful acts they may commit. As a result, many civil servants used great discretion in applying the rule of law: "politically-connected" citizens received favorable treatment (e.g. land use and public health violations were ignored, tax evasion was not sanctioned, etc), whereas the full weight of the bureaucratic complexity of rules and regulations was applied to "unimportant" citizens. The latter, fully cognizant of the formal power of the bureaucracy to invent obstacles to the timely settling of the issues at hand, were often induced to offer bribes for the timely (but not unlawful) clearing of the matter. The continuous sharing of experiences among citizens regarding their dealings with the state bureaucracy, along with the increasingly apparent indifference of the state apparatus (including the legal system) to the unlawful conduct of many civil servants, led, albeit perhaps grudgingly, to the "normalization" of this situation, and to a political culture that was not kind to the apparently Quixotic efforts of some citizens to officially report on such occurrences.[9]

The gradual weakening of state power did not go unnoticed by the private sector. Sometimes forced by the blatant extortion exercised by civil servants, sometimes taking the first step in nurturing a mutually beneficial relationship, private interests captured the day-to-day functioning of public administration and distorted the implementation of economic policy. The infiltration of public administration by private interests (operating both *within* and *outside* the formal state apparatus) is responsible for the dismal prospects that Greece faces. The Greek crisis arose from the confluence of several basic factors.

First, Greece's large fiscal deficits until 2008 were not incurred for economically sound reasons; they were neither a deliberate macroeconomic response to the dangers

[8] The term "developmental state" is meant to indicate the benevolent power exercised by an autonomous elite state bureaucracy that has the ability and the foresight to channel funds to productivity and competitiveness enhancing activities. In contrast, the "intermediate state" lacks the required autonomy, integrity, cohesiveness, and proficiency to fully implement desired reforms and is often captured by private interests.

[9] For arguments as to why economists should take seriously the impact of the political culture on the economy, see Hillman and Swank (2000).

of serious recession nor were they associated with an increase in the quality of publicly provided goods and services. Rather, the budget deficits of the previous decade must be seen as reflecting either lack of ability (or complicity) among governments to stem the predatory behavior of powerful elites to raid the state coffers. We note that, in contrast to other empirical evidence (e.g. Brender and Drazen, 2008), Greek voters do not seem to punish governments for fiscal deficits.[10] Instead they seem to reward the policies that the deficits finance (e.g. an increase in public employment). Such behavior may not be 'myopic' since tax-evading individuals rationally anticipate that they will bear a low share of the burden of future fiscal adjustment.

Second, a crucial factor, which has been steadily eroding the foundations of Greek society and will impact on the resolution of the current fiscal crisis, is the interdependence between the tax burden, public good provision, and tax compliance. The necessary reduction in the budget deficit involve political choices that include higher taxes, lower (hidden) subsidies to private firms, lower wages for public sector employees, and lower social entitlements. However, these choices will prove unpalatable unless the public sector delivers on the public goods and services, which higher-taxed citizens (i.e., the law-abiding ones who do not evade taxes and thus face tax burdens significantly higher than the economy-wide average) will have every right to expect in return. It is difficult to see how this will be achieved given that the low quality of publicly-provided goods is *perceived* by public sector workers to be a result of low public sector wages.[11]

Third, only if citizens receive the expected quality of services from the public sector - and thus they do not have to source some of these services at a fee from the private sector - it may be possible to adjust wages by the required amount so as to address the loss in competitiveness and the extremely large current account deficits that Greece has been running for many years. In this respect, the rise in unit labour costs in Greece relative to the other eurozone countries may appear to reflect an inherent inability of the Greek trade union movement to accept real wage increases for private sector workers in line with productivity developments. However, the data do not support such a conclusion; in fact, real wage increases in the private sector have, for a long time, been lower than productivity increases (see Fotoniata and Moutos, 2010). Private sector workers have thus not benefitted from the expansion of the public sector; instead, private sector workers have been disadvantaged by the higher public sector prices and/or taxes due to higher public sector wages (and employment increases). The upshot of these developments is that the loss in Greek international competitiveness is attributable to the struggle of workers to maintain their real after-tax wages (net of publicly-provided services) intact, as the tax burden has been increasing without an equivalent increase in the provision of public goods.

[10] Logit regressions, as in Brender and Drazen (2008), for Greece performed by the authors suggest that average deficits when the incumbent is in office (or just in the pre-election year) increase re-election probabilities.

[11] This perception on the part of public sector workers is not borne out by the data. For example, the cumulative increase in nominal wages per person from 1995 to 2006 was 82% in the private sector (excluding the banking sector), whereas the cumulative increase in public sector wages was 118%, and in publicly owned enterprises 157%. These large differentials in the evolution of pay not only make working for the private sector a less attractive option, but are also associated with higher tax rates and/or higher (relative) prices of publicly provided goods and services, since they hardly reflect differential increases in productivity between the public and private sectors.

Fourth, the large increase in taxation (since 1975, tax revenue have increased from about 25% to about 40% of GDP) without an equivalent increase in the provision of public services has discouraged tax compliance.[12] A common complaint amongst citizens is that they have been "forced" to spend an increasing share of their income on privately-provided services, in order to complement the worsening quality of publicly-provided ones. (This "loss" of income available for other private consumption was particularly acute for middle and low-income households, which after EMU responded by taking on more debt – we discuss this issue in the following section). We mention two prominent examples of such expenditures, which cover both the pre-EMU and the EMU period. The first results from the *numerus clausus* arrangements regarding entry to tertiary education in Greece, and the attendant competitive national examinations. Although there has been a large rise in the proportion of students admitted to tertiary education during the last 35 years (from about 15% of the high-school graduates in 1974 to about 40% in 2008), thus lessening the competition for the available places, private spending on crammer schools preparing students for the national exams has increased; Kanellopoulos et al. (2003) estimate that the share of education expenditures in household budgets rose from 2.15 % in 1974 to 4.41% in 1999, and KANEP (2009) estimates that in 2005 this figure had risen to 5.09% of household budgets. The second refers to health care, for which many attempts at efficiency-and equity-enhancing reforms have been prevented by powerful elites (e.g., professors in medical schools) – for details, see Mossialos et al (2005). The deterioration in the effectiveness of health care provision in Greece has been documented by Data Envelopment Analysis; OECD (2009b) estimates that between 1990 and 2006 the relative efficiency of Greece's health care system eroded significantly, and that this decline in performance stems more from a decline in technical and organizational efficiency rather than from higher input prices. This rise in private spending reflects the widespread perception of a continuing deterioration in the quality of publicly-provided education, and it has led to a decrease in the stigma attached to tax evasion, and reduced voluntary tax compliance.[13]

Finally, the continuing, and possibly increasing, incidence of tax evasion[14] privileges the non-traded sector at the expense of the traded sector since it is more prevalent in non-traded goods (medical and law services, car repairs, etc) than in traded goods. This creates a vicious circle in which the efforts of government to collect more taxes by raising tax rates shifts resources to the sector more prone to tax evasion, thus, in the medium-term, worsening both the fiscal and the current account deficits. It also, in tandem with other forms of inefficacy and corruption in all aspects of public

[12] This implies that tax evasion in Greece may be thought as a way to limit the economic consequences of government inefficiency (Myles, 2000).

[13] The issue of voluntary compliance is particularly pertinent in Greece, as the labyrinthine tax code not only discourages taxpayer compliance but is also widely perceived to be the result of both ad-hoc policy interventions, and of *intentional* design; i.e. tax officials design a complex system so as to force honest taxpayers to be resigned to the fact that a tax audit will uncover irregularities, thus reducing their incentives to devote much effort to tax compliance and inducing them to offer up-front readily accepted bribes to tax auditors. Marjit et al (2000) describe a relevant 'harassment equilibrium' in which citizens decline the option of going to the court to protest against the 'harassment' of the tax auditor and accept the bribe offer.

[14] Schneider (2005) estimates the size of the shadow economy in Greece to be the largest (as a proportion of GDP) among 21 OECD countries. His estimates hover between 25 and 30 percent of GDP.

administration, results in inefficient firms surviving and preempting would-be productive firms.

We can now summarize how the above factors have interacted result in the dismal Greek situation. Increases in public employment and tax rates, without attendant increases in publicly provided goods and in tax revenue, along with the shouldering of the financial obligations of inefficient private sector firms, led to both public debt accumulation and increased wage demands by private sector workers and a weakening of private sector performance and employment opportunities, which in turn induced the "nanny" state to intervene (as an employer and lender of last resort) in order to alleviate what it was co-responsible for creating in the first place, thus leading to further debt accumulation and providing new impetus to the vicious circle. Stamping out on the cancerous "collaborations" between private interests and the (formally) appointed custodians of the public interest is the only way to break up the vicious circle in which many firms survive due to government kickbacks[15] while at the same time the government acts as the "employer of last resort", thus both shouldering the obligations of inefficient firms and burdening workers and efficient firms with unnecessarily high tax rates and excessive red tape. The multifaceted crisis of the Greek economy and society may force an end to this vicious circle, if the loop's causality is correctly diagnosed and there is the attendant political capital to enforce the necessary reforms.[16]

3. EMU's excessive reliance on the SGP

The Greek crisis, mainly government-induced, provides *prima facie* evidence in favor of the SGP's focus on government balances. Nevertheless, the Greek case also highlights that the interdependence between government and current account imbalances can create a semblance of fiscal prudence when none exists; the experience of Spain and Ireland[17] can hardly absolve private-sector debt accumulation from malign repercussions, and it should not be forgotten that often banking crises cause sovereign debt crises, which in turn, through contagion, precipitate further banking crises (Reinhart and Rogoff, 2010).

We contend that the harmful effects on public finances produced by Greece's political-economic equilibrium are not, on their own, enough to explain the country's current predicament. Greece's inability to access private financial markets has been a consequence of the fact that a constantly increasing share of its public debt is

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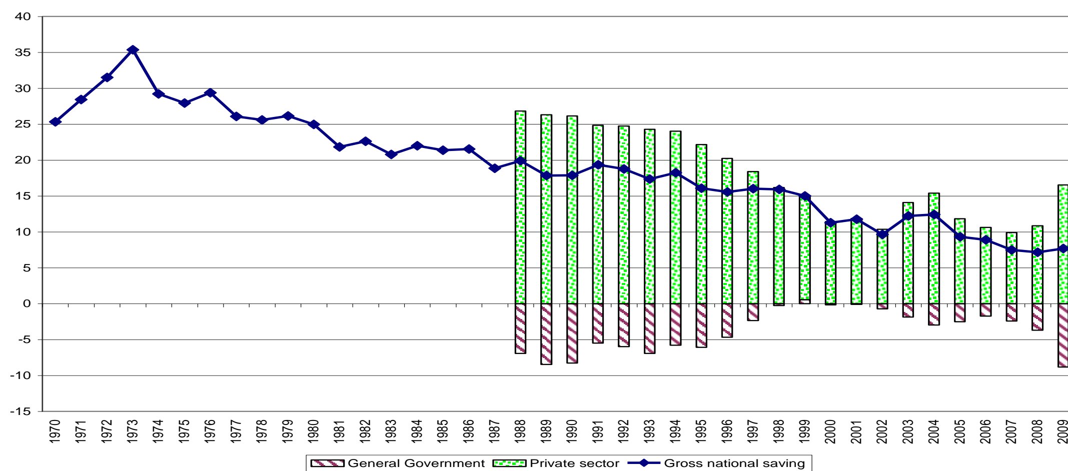
[15] We note an example of how the tax system has been used to this effect. Political parties, in complicity with the party's "own" trade union representatives, have been turning a blind eye to the shenanigans of the tax officials. This has allowed political parties to cater to private-sector interests both ex-ante (e.g. tax expenditures) and ex-post (e.g. allowing "politically influential" employers, such as owners of newspapers or TV stations, to carry forward their payroll tax obligations under the implicit understanding that they will never have to pay as long as they provide a friendly forum for the political party in power).

[16] An alternative interpretation has causality running from an inefficient private sector whose apparent success in the past relied on the heavy protection (cum subsidies) accorded to Greek industry. This came to an end after Greece joined the EEC in 1981, which "forced" the Greek state to become "employer of last resort" (Tsakalotos, 1998). We note that in 1981 there was also a "regime" change in Greece with the rise to power of a Socialist government and the intensification of the politicization of the bureaucracy, thus making it very hard to disentangle the influence of each factor.

[17] Both Spain and Ireland were run by fiscally prudent governments – they never violated the SGP and had budget *surpluses* on average.

externally held (the projected level of *net* external debt for 2010 is 99% of GDP), which compromises the perceived ability (and willingness) of the country to keep honoring its debt obligations to foreigners. The explanation for this development must be sought not so much in the decline of the government saving rate but in the decline in the private sector's saving rate. Starting from 1974, there has been a steady decline in the saving rate, with the net saving rate dropping by about 25 percentage points (from 20% to minus 5%).[18] This huge drop in the national saving rate has (since 1988) *not* been associated with an increase in government borrowing, but is wholly attributable to the decline in the private sector's gross saving rate (from 27% in 1988 to 11% in 2008).[19]

Figure 3: *Gross National Saving - % GDP*



Source: Ameco.

The decline in the national saving rate experienced by Greece parallels the declines observed in many other euro area countries, but in no other country has the decline been so pronounced. Given the absence of any trend in the (national) investment rate, the consequence of the large decline in national saving for Greece has been a gradual widening of the current account deficit and the accumulation of foreign debt. The current account deficits incurred after 1997 have been responsible for increasing the country's negative net foreign asset position as a proportion of GDP from 3% of GDP in 1997 to 86% of GDP by the end of 2009[20] (IMF, 2010). With the exception of Iceland, Greece's net foreign indebtedness is the largest among developed countries (IMF, 2010). The rise by 84 percentage points in net foreign indebtedness dwarfs the

[18] The difference between gross and net saving is depreciation of capital (i.e., capital consumption). We also note that gross government saving is defined as the difference between gross government income and government *consumption* expenditure.

[19] The decline in the saving rate was aided by the aggressive peddling of credit at very low interest rates (relative to what Greek households were used). Both the banks (due to the implicit guarantees, which they, correctly, assumed that they were enjoying) and the governments were happy to allow such an unwarranted credit expansion since it, temporarily, diffused the social tensions arising from the increase in income inequality and increase in private spending on supposedly freely-provided public goods. We do not have an explanation as to why neither the domestic monetary authorities (Bank of Greece) nor the ECB took measures to slow down the rate of credit expansion.

[20] The rise in foreign indebtedness could have been caused by valuation effects; however, if anything, valuation effects have, most likely, dampened the rise, which would result in their absence since the Greek stock market at the end of 2008 was below its 1997 level, and there were no significant exchange rate changes.

13 point rise in the public debt-to-GDP ratio during the same period (from 102% in 1997 to 115% in 2009).[21] Consistent with these facts, current account deficits as a proportion of GDP from EMU entry (2000) until 2008 were on average 8.3% p.a. During the same period, the average budget deficit was 5.3% p. a., implying that the private sector not only was not able to finance the government's budget deficit, but was also a significant net contributor to the country's net foreign indebtedness.

In a closed economy, the interest payments the government makes to the holders of public debt (i.e., domestic residents) are part of their income and of their tax obligations to the sovereign. The same could still be true in an open economy if an abundance of domestic savings over domestic investment (i.e., a current account surplus) allowed the government to finance its deficits from domestic savings (e.g., the case of Japan). In contrast, as in the Greek case, a deficiency of national saving over national investment implies that either the public sector and/or the private sector cover their deficits from foreign funds.

When a large proportion of public debt is held externally and debt interest payments are a large proportion of the country's GDP, foreign investors may start to question the ability (and/or willingness) of the government to generate the resources needed for debt service to foreigners.[22] In the case of Greece, the interest payments made to foreigners were 3.8% of GDP in 2009 - a very large figure by historical standards. In the first months of 2010, market estimates for this figure had it rising to, at least, 5% of the country's GDP in the near future, *under the assumption that interest rates would not rise*. The ability to continue making these payments to foreigners depends crucially on the desire of Greek citizens to reduce consumption, investment or government spending by an equivalent amount. One may think that, say, 5% of an individual's income is not a large percentage (after all, many banks are willing to provide mortgages that involve payments in excess of 25% of the borrower's income). However, on an aggregate basis such a figure is very large since an increase in, for example, household savings by more than 5%[23] (in order to satisfy the country's international obligations) may well generate a large recession, thus increasing further the foreign debt burden and the probability of default. Under these conditions, foreign creditors started demanding interest rates that embodied a high probability of default; this, in turn, forced the Greek government to seek official help, since paying the higher interest rates demanded by the foreign creditors made default in the near future a foregone conclusion.

But would the Greek predicament be any different if the external debt was all private? (Private debt was in 2009 about one-third of Greece's total external gross debt.) In other words, what if successive current account deficits were the result of private sector financial imbalances only? The "Lawson doctrine" (named after the former Chancellor of the Exchequer Nigel Lawson) claims that a large current account deficit is not a cause for concern if the government budget is balanced. In the same vein, Corden (1994) stated the policy implications of the intertemporal approach to the

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[21] The imprudence shown by Greek governments during this period seems to match the reckless behavior exhibited (in the aggregate, although it may have been sensible at an individual level) by private sector domestic borrowers and foreign lenders.

[22] Truman (2005) presents various other reasons as to why foreign investors may not wish to increase their credit exposure to highly indebted countries.

[23] The increase in the saving rate needs to be larger than 5% since consumption is less than GDP.

current account with these words: "… an increase in the current account deficit that results from a shift in private sector behavior – an increase in investment or a fall in savings – *should not be a matter of concern at all"* (emphasis added).[24]

It appears that the designers of the SGP had a considerable amount of faith in Lawson's doctrine as testified by the overwhelming focus of the SGP on fiscal balances,[25] and the complete absence of any reference to current account imbalances. Yet, the Latin American debt crisis in the 1980s should have shaken the belief that current accounts deficits are not an issue of concern to policymakers, since some of the countries had run very large current account deficits in the presence of balanced budgets (e.g., Chile's very high current account deficit was associated with a balanced budget and rising investment). The subsequent Mexican and East Asian crises in the 1990s had changed the profession's attitude towards current account deficits: Milesi-Ferreti and Razin (1996) summarized the conventional wisdom thus: "… current account deficits above 5% of GDP flash a red light, in particular if the deficit is financed with short-term debt."

While there is no doubt that some of the causes of current account imbalances can be a benign reflection of differences in underlying economic fundamentals across countries (e.g. demographic patterns, levels of development), they can also be a malign reflection of market imperfections and externalities (see, Blanchard, 2007). For example, low private saving, which –ceteris paribus- results in a current account deficit, may be a result of overoptimistic expectations of future growth, of underestimation of future real interest rates, or of unsustainable real estate or stock market bubbles –all of these factors clearly played a role in the Greek case. But it is also important to note that even if the underlying factors behind current account deficits are benign, the presence of externalities and macroeconomic interactions may result in undesirable outcomes. For example, inward capital flows may result in real exchange rate appreciations that force declines in manufacturing activity through plant closures which are difficult to reverse, possibly leading to protracted periods of unemployment. Moreover, the unwinding of unsustainable current account deficits may be particularly difficult since the required real depreciation may be difficult to

[24] Moreover, under the presumption of efficient financial markets, current account deficits reflect the individually optimal decisions of borrowers and lenders, and policy intervention to reduce deficits is unwarranted since it would lead to welfare losses. The experience of many countries runs contrary to the *consenting- adults* view of the current account and there are counterarguments at a theoretical level.

[25] The overwhelming focus of the SGP on fiscal balances can also be explained by the concern of the richer Northern countries to avoid turning the currency union into a *transfer* union. Although this is, in general, a valid concern, sometimes the cases mentioned in the press (e.g. Northern taxpayers implicitly subsidizing the early retirement of Greek citizens) were ignoring some crucial parameters of the issue. Thus, despite the scandalously early retirement age for some "privileged" groups, the *average* age of actual retirement in Greece is very close to the eurozone average (see https://community.oecd.org/community/factblog/blog/2010/02/03/keep-on-working) and the annual hours worked are significantly higher (by more than 20%) than the eurozone average. On the other hand, both the gross and net pension replacement rates are significantly higher in Greece than in the eurozone (see http://ec.europa.eu/employment_social/social_protection/docs/isg_repl_rates_en.pdf). Although we are not aware of any study that takes all these considerations into account (in addition to the contributions paid) to produce a measure of the "generosity" of the pension system in each country, the non-sustainability of the pension system in Greece was in June 2010 not in doubt; changes in many parameters of the pension system (the bailout package is conditional on their implementation) may well ensure both the sustainability of the system and reduce the budget and current account deficits (due to increased need for private saving).

achieve in currency unions when the inflation rate of the other member countries is low.

What the previous paragraph implies is that the real issue in large current account deficits driven by private sector behavior (that large current account deficits can be malign if driven by irresponsible fiscal policies is not in dispute) is the interaction between separate national economies and market imperfections (including corporate governance). If, for whatever reason, too many residents of a country have gone on an unsustainable borrowing spree (testified by a large current account deficit as a proportion of GDP), the sudden realization by the markets (induced, for example, by an exogenous event altering the perceived fundamentals) of the "riskiness" of the country will cause a "sudden stop" (Calvo, 1998) in capital inflows. It has been known for a long time that private-sector lenders pay particular attention to "country risk" in pricing their loans to private-sector borrowers (see, Harberger, 1980). As long as, and despite the existence of a currency union, economies remain national in character (e.g. due to the well known home-bias in spending patterns and lack of labor mobility across countries) it is understandable that lenders would want to reassess the riskiness of previously sound borrowers (including domestic banks) whose revenue (or employment) depends mainly on the state of the national economy. The resulting credit crunch will cause a major disruption in the economy's operation and, in addition to a serious recession, leave as a legacy a large number of unfinished projects (e.g. real estate developments) lain to waste.

Issues of corporate governance are of vital importance in completing the picture regarding the undesirability of large current account deficits. After all, there must be willing lenders. But as the subprime crisis in the United States has demonstrated, lenders can take the initiative in providing credit to risky borrowers; it has also demonstrated that lenders are unable (or unwilling) to think of the systemic implications of their actions. The incentives of managers are not often aligned with prudent lending practices. Bank managers have found that it is individually optimal to avoid prudence and follow the dictum of the CEO of Citigroup, Charles Prince: "…as long as the music is playing**,** you've got to get up and dance**…**we're still dancing" (www.reuters.com/article/idUSN0819810820100408). The implicit loan guarantees provided by governments have also intensified private sector moral hazard,[26] but there is no doubt that many crises in the past centuries were caused despite the absence of government intervention (Kindleberger and Aliber, 2005).

Why did economic governance in the eurozone underestimate the role of current account imbalances? Why should it be expected that capital inflows to peripheral EMU members would not produce an increase in inflation that, under a common monetary policy, would lead to lower real interest rates (the Walters critique) and consumption and investment booms that would produce unsustainable current account imbalances? Should one expect that the investment booms would result in productivity increases, which would be translated into trade account improvements that would offset the interest-income payments that remain as the legacy of the initial capital inflows? If these mechanisms proved inadequate, what, but sudden stops in capital flows and the associated sharp output drops, would stop foreign debt from

[26] Underpriced loan guarantees (including implicit guarantees) lead to both greater lending, due to the lower cost of capital, *and* riskier lending, in order to maximize the value of the guarantee (see, McKinnon and Pill, 1997).

reaching stratospheric heights? Why was it assumed that such occurrences would not produce the contagion effects that were seen in previous balance of payments crises, especially since the euro brought along deeper financial integration (i.e., it created an inter-connected banking system between the surplus and the deficit member states)?

With hindsight, we know that these questions were dodged by the prevailing wisdom that current account imbalances generated by private sector behavior were reflecting nothing more than optimal contracts between "consenting adults", and thus they should not be the objective of government policy. The sanguine view taken towards current account deficits within the eurozone may have been influenced by the idea that foreign debt crises afflict only low-income countries, and that currency mismatch problems are a major factor in this respect. The fact that the peripheral eurozone countries could issue debt in their *own* currency appears to have allayed fears regarding currency mismatch problems as well as contagion effects; nevertheless, the consequences of the inability of the peripheral eurozone countries to exercise an independent monetary policy were ignored. But beyond this act of omission, the deficiency of economic governance in the EU may have also been an act of commission.

The EU Commission has so far approached the issue of macroeconomic (i.e. current account) imbalances in the euro-area through open coordination methods such as the Broad Economic Policy Guidelines. Given the lack of political will for closer integration of economic policies, it is understandable that policies for coordinating private sector imbalances would be highly unlikely to be implemented. Moreover, it would have appeared inconsistent for the Commission to sing the praises of unfettered capital markets and promote capital market integration, and at the same time make current account imbalances of individual countries a policy target. The belief that the only threat to the viability of the EMU project could be due to imprudent government behavior in the member states shows, in retrospect, that a crucial political-economic interaction between private debt and government debt was ignored; this interaction arose from the implicit government guarantees that too-big-to-fail banks seemed to enjoy and that induced them to excessive cross-country lending to the private sector, mainly through the intermediation of the local banks. When the global financial crisis erupted, euro area governments had to step in and make good their implicit guarantees to the banks, thus precipitating the current fiscal crisis for (previously) fiscally prudent countries as well.

We end by noting an asymmetry that the SGP imposed on euro area countries. Given that global political economy concerns[27] place an upper limit on the size of the eurozone current account surplus (but not on the current account surplus of each eurozone country), improvements in the current account of deficit countries within the eurozone must coincide with smaller surpluses in the rest of the eurozone. If governments were to intervene in deficit *and* surplus countries (by fiscal contractions in the former group and expansions in the latter group), the shrinkage in current account imbalances would be associated with improvements in the fiscal stance of one group and deterioration in the other. However, if current account surplus countries (e.g., Germany) were already operating with budget deficits near (or, slightly above) the 3% limit of the SGP, fiscal expansion at home would breach the SGP limit; the

[27] For example, the US-China currency dispute due to the large Chinese current account surplus.

onus of adjustment would have to fall only on countries with external deficits (see Ahearne et al, 2007). Finding policy tools, which, even if they are implemented by only one set of countries, directly impact on both set of countries (the exchange rate does this if countries do not share the same currency), should be a policy priority.

4. Conclusion

There is no doubt that Greece's dismal prospects are a result of deficient norms and institutions with fiscal profligacy one of the primary consequences. Yet, the fact that the SGP has unraveled, requiring large scale bailouts and direct sovereign bond purchases by the ECB, should not lead to the belief that asserting fiscal discipline within the eurozone should be the top and only priority of policymaking. Current account imbalances within the eurozone should also feature in any reform of the current structure of economic governance (for example, by requiring countries running excessive current account deficits to raise VAT rates even if their budget deficits are not excessive; raising VAT rates has similar effects as an exchange rate depreciation, since the VAT is a consumption tax that promotes the production of exportables.

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