Why was the Euro Area Crisis Mismanaged?

The Political Economy of the European/Greek Debt Crisis

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The Problem

- Unemployment Rates in the euro area (April 2016) ranged from 4.2% in Germany, to 9.9% in France, to 11.7% in Italy, to 20.1% in Spain, and to 24.2% in Greece.
- The decade-long (2004-2014) average annual GDP growth rates ranged from -2% for Greece, to -0.5% for Italy, to -0.3% for Portugal, to 0.9% for France, and to 1.3% for Austria and Germany. (No country suffered a similar drop in its GDP during any decade around the 1930s Great Depression as has been experienced by Greece recently.)
- Public debts, for all of the EA12 countries, are above the 60% Maastricht limit.
- Interest rates are close to the Zero Lower Bound (ZLB), and the ability of the ECB to conduct monetary policy is compromised.

What are the causes of this failure?

- Could it be that the creation and composition of the EMU was a bad idea?
- Is it due to “technical” mistakes in the handling of the crisis?
- Is it due to the inability of the economic and political institutions in the countries most affected by the crisis to implement the (correctly diagnosed) reforms?
- Is the mismanagement of the crisis due to the political structure of the euro area that leveraged the power of some member state governments against the interests of other member states and the euro area as a whole?
- Can something be learned by studying the first EU/IMF/ECB rescue programme for Greece?

- The creation and composition of the European economic and monetary union (EMU) was based primarily on political criteria.
- Prominent economists, on both sides of the Atlantic, including supporters of the European project, had expressed serious misgivings about the adoption of the common currency even before the introduction of the euro.
- In 1996, Rudiger Dornbusch concluded: “If there was ever a bad idea, EMU is it.”
- Yet, the ECB, in its appraisal of the first decade of the euro, considered it a success.
- What went subsequently wrong?

- The GFC in 2008 exposed fragilities in numerous economies that persisted even after the global economy started to recover a year later.
- The GFC threatened the banking sector, especially in Belgium, France, Germany, Ireland, and the Netherlands.
- In Germany, the collapse of banking institutions forced the government to undertake costly bailouts of German bankers which were paid for by taxpayers, fueling public resentment.
- Managing German public opinion to preserve the political success of the German government may have been decisive for the subsequent handling of the euro area crisis.
- But the issue that marked the beginning of the euro area crisis was of a different nature. It was an excessive indebtedness problem in Greece.

- Greece faced many –and to a larger degree- of the macroeconomic problems commonly encountered in countries turning to the IMF for help.
- However, the fact that Greece was in the euro area created some uncommon challenges, i.e. it did not have control of its own monetary and exchange rate policies.
- The design and implementation of an IMF program for Greece required coordination of policies with other euro area governments and institutions.
- The resulting complications led to decisions by euro area governments and institutions and the IMF that transformed the problem from what could have been handled as an ordinary IMF program for Greece in 2010 into a systemic crisis for the euro area as a whole.

- This was because the euro tied member states together, necessitating cooperation among governments. The absence of a crisis management mechanism generated the need for addressing questions not foreseen in the EU Treaty.
- Since unanimous agreement of the member states is effectively required to address many of these questions, the governments of other euro area countries acquired an outsized influence on the management of the crisis in Greece.
- In contrast to other IMF programs, the design and implementation of an IMF program for Greece (and also for other euro area member states) effectively became subject to the approval of each of the other governments of the euro area.
- The result was the domination of the decision making process by conflicting financial and political interests among euro area countries.

- Standard prescription of IMF programs is fiscal austerity. An element of austerity is unavoidable to correct imbalances and restore long-term internal and external balance.
- Fiscal austerity is usually a source of both economic and political risk which could lead to the failure of a program.
- Austerity typically creates a political backlash against any government that implements a program—an expected consequence of countries plagued by populist politics.
- As a result, austerity beyond the breaking point of a democracy becomes counterproductive for political reasons.
- Excessive austerity that leads to outsized drops in production becomes counterproductive for purely economic reasons

- Two additional factors required attention in the design of the Greek program, both consequences of the fact that Greece was a member of the euro area.
- First, to regain competitiveness Greece would need to go through internal devaluation, which is a slower process than an adjustment with a weaker currency, suggesting that a successful IMF program might have required a more gradual fiscal adjustment process to avoid an austerity induced collapse in economic activity.
- Second, given the relatively high initial debt level, had the IMF deemed the Greek government debt unsustainable, it would have required a restructuring at the start of the program, so that debt becomes sustainable with “high probability”.

- Since Greece was in the euro area, direct consultation with the IMF to design a suitable program without the involvement of other euro area member states, was ruled out.
- In the event, the French and German governments took a leading role in the design of the program that was imposed on Greece in May 2010.
- Participation of European governments in the funding of the program also implied that the program had to be approved by individual governments of the euro area and in some cases, for example for Germany, be subject to parliamentary hearings and approval.
- As a result, local political considerations in other euro area member states were introduced into the design of the program for Greece.

- In May 2010, the IMF Board approved a program providing 110 billion euro of financing, 30 billion from the IMF and 80 billion from EU governments. Two elements of the May 2010 program are noteworthy:
- First, that no restructuring of Greek debt was needed for its success. According to the IMF : "With *disciplined* program implementation, Greece's debt is expected to be sustainable in the medium term, and its repayment capacity to be adequate" Under the IMF baseline scenario, Greek debt was projected to rise from 119 percent of GDP in 2009 to 149 percent in 2013 and subsequently decline gradually to 120 percent by 2020. The staff could not assess that the debt would remain sustainable with "high probability." The IMF Board circumvented this by introducing a "systemic exception" to that criterion.
- Second, the program called for unprecedented fiscal adjustment, turning a primary deficit of -8.6% of GDP in 2009, to a primary surplus of more than 6% in 2014, and beyond (thus, sustainability would be attained…).

- The absence of exchange rate flexibility would imply that a more gradual fiscal adjustment was preferable, yet a “punishing” adjustment was “agreed” on.
- Was this because from a German political perspective, as long as the IMF deemed that the program could succeed, the harsher the austerity measures, the easier would have been for the German government to get parliamentary approval?
- We now know that the Greek economy collapsed, but the discussion goes on whether this was due to poor implementation, to bad program design, or due to other considerations…

Was failure of the program due to the political manipulation of reality by politicians trying to shape public opinion so as to serve their political aspirations.

According to the “Athens narrative”:

- Germany exploited its power to block an ordinary IMF program and instead supported a plan of action that imposed excessive debt on the Greek people.
- The austerity policies forced on Greece by the German government through the Troika have pushed Greece into a debt trap.
- The German government should accept its responsibility and agree to a compromise that eases the debt burden of Greece.

According to the “Berlin narrative”:

- German taxpayer money has been financing Greek profligacy since 2010, and has allowed tax-evading Greeks to transfer their wealth abroad.
- Greek governments since 2010 have consistently failed, despite the generous support provided by Germany.
- Greek governments must engineer further austerity measures so they can honor their commitments or else Greece does not belong in the euro area.

What was the 2010 program about?

- According to the former Bundesbank President Karl Otto Pohl "It was about protecting German banks, but especially French banks, from debt write offs" (Reuters 2010). (The Financial times reported that French and German banks and insurance groups together held 80 bl euro of Greek government debt).
- A Greek program that did not involve a restructuring of Greek government debt would have protected German and French financial institutions from losses.
- To the extent this was just a beneficial side effect of a well-designed program for Greece that did not require debt restructuring this would have not been objectionable. But Pohl's remark suggested that protecting the French and German banks was not a side effect but rather the central objective of the design of the Greek program.

- In June 2013, the IMF published an ex post evaluation that provided a valuable assessment of what had gone wrong. The report noted that:

(i) IMF staff had made clear that risks were such that debt was "not judged to be sustainable with high probability" which would imply ex ante debt restructuring. A "systemic exemption" was introduced as a justification, since "restructuring risked contagion to other members of the Eurozone." Also it was claimed that a "rescue package for Greece that incorporated debt restructuring would likely have difficulty being approved, as would be necessary, by all the euro area parliaments."

(ii) that debt restructuring was "ruled out by the euro area."

(iii) the program served as a "holding operation" that "gave the euro area time to build a firewall to protect other vulnerable members and averted potentially severe effects on the global economy."

- A lesson drawn by the report was that: “Earlier debt restructuring could have eased the burden of adjustment on Greece and contributed to a less dramatic contraction in output. The delay provided a window for private creditors to reduce exposures and shift debt into official hands. This shift occurred on a significant scale and left the official sector on the hook.”
- The Wall Street Journal (2013) published confidential documents reporting details of the May 9, 2010 IMF Board meeting revealing severe disagreements among IMF board members and a thorough understanding of the adverse implications of the program for Greece, suggesting that the IMF knew that the program was doomed to fail.

Given these objections why was the program approved?

Possible reasons include:

- The large influence of the larger euro area countries in the IMF (e.g. DSK).
- The Dutch, French, and German governments indicated that their banks will maintain their exposure to Greece.

But reality proved different. The French and the German banks started quietly unloading their Greek government debt.

From a distributional perspective a key question is: Should Greece be forced to bear the ***additional*** cost of deviating from the IMF's established procedures (i.e. early restructuring)?

- If efficiency required that the IMF deviate from its principles, rather than rule out the restructuring and shift the burden to the Greek people, the IMF could have given other euro area governments a choice.
- Karl Otto Pohl proposed to reduce Greek debt by one-third which, counting only the debt held outside Greece, would have reduced the Greek debt outstanding by 67 bn euro. Then the IMF could say to the creditor countries. Either pay 67 bn euro in exchange for deviating from the rules and avoiding a restructuring, or come to terms with the consequences of the restructuring which would proceed according to the established rules.

- In May 2010 the risk of contagion constituted a legitimate concern for the euro area as whole.
- The real mistake was that the IMF allowed the "systemic exemption" to be used as a pretext for shifting crisis-related losses from stakeholders in other euro area member states—importantly French and German financial institutions—to the Greek people.
- The IMF (2014) has acknowledged that the systemic exemption is "perceived to be inequitable and excessively open-ended" and has been reviewing possible reforms to its lending framework.
- This mistake compromised the IMF's rules-based lending framework to create room for discretion that could be exploited by certain euro area governments to serve their own interests to the detriment of the country that had requested assistance. In the words of former IMF official O. Mandeng : "key IMF programme decisions are taken outside the Fund" (Mandeng, 2013).