Eyes Wide Shut

Visionary hubris provoked the Greece-euro crisis

Karen Horn | **The Greek debt crisis and the threat of national bankruptcy have severely tested the European Union and its common currency. Exactly this magnitude of snafu happens when policymakers give free reign to visions. Europe's politicians ignored the economic writing on the wall in the interest of "higher" principles—and paid a very steep price.**

No one can claim that the calamities involving Greece and other shaky euro-zone economies were not foreseeable. Europe walked into this crisis with its eyes wide shut. Anyone who now professes surprise must have slept through the extensive debate on fundamentals that preceded the euro's introduction. This debate addressed the spirit and purpose, the opportunities and risks, the action mechanisms, and the timing and structure of monetary union. It also involved considerable intellectual wrestling with the logically possible consequences of (desired) economic and (contentious) political union. In 1992, prior to the introduction of the euro, a group of 62 German scholars issued a memorandum on the conclusions reached at Maastricht. Their words were auspicious: mistakes made at Maastricht, they argued, would "expose Western Europe to intense economic pressures that can lead to a severe test of political will and thus endanger the goal of integration."[1]

The paramount question here is not actually whether Greece's lack of solidity and its fraudulent accounting could have been detected earlier. However, it deserves examination as a preliminary step toward addressing the more important issue of whether, from its inception, the whole monetary union project had a clubfoot that Europe's political visionaries chose to ignore.

At least since the first "statistics scandal" of 2004 it has been clear that the Greeks falsified statistics, lied to partners, fudged figures relating to the stability criteria for the euro zone, cheated their way into monetary union, and thus spuriously obtained the "euro dividend"—the concrete economic advantages of monetary union—at the expense of other members. The scandal revealed gross inaccuracies in statistics submitted between 1997 and 2000. Greece—which

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[1] http://www.aurecon.com/finplan/euro/920611_62-prof.htm.

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was initially excluded in 1999 from the third level of economic and monetary union and only admitted in 2001—should never have been allowed in.

However, the Greeks not only fabricated statistics, and continued to do so, as a recent investigation by the European Commission revealed. Ultimately statistics can only record figures that are actually available. In this sense, the whole external image of the Greek economy is a fabrication. Corruption and illegality are ubiquitous. Every fourth euro disappears into the shadow economy as a result of tax avoidance and the failure to pay social insurance contributions. Despite the "euro dividend," which meant that Greece has long been able to borrow at the favorable conditions of the euro area—thereby importing credit-worthiness and enjoying price stability—the Greek economy suffers from structural problems that have a long and well-known history. At 12 percent of the gross national product, its current-account deficit remains extremely high. Like the other members of the so-called "PIGS," Portugal, Italy and Spain, Greece has never had a very competitive economy.

Now the horse has bolted. If we give statistics from Athens any credence at all, then we have to recognize that Greece's budget deficit climbed to 13 percent of GDP in 2009, far above the 3 percent line enshrined in the Maastricht criteria. In 2010 total indebtedness will reach 125 percent of GDP, the highest level in the entire European Union and more than double that allowed by the Treaty of Maastricht. The E.U. Commission has launched proceedings against Greece based on the violation of E.U. treaties and obliged the government to present its cost-cutting measures in Brussels every three months. The austerity programs the Greek government is now putting into place have immediately drawn opposition from the unions, which have organized strikes and protest rallies.

What measures are on the table? Public spending is being radically trimmed and public-service salaries frozen. The government claims it is aiming—whatever that means—to reform the tax system and social security. Firms will have to pay back 200 million euros worth of state subsidies acquired in contravention of E.U. law. However, given that the Greek economy will shrink this year by at least 2 percent, these measures are questionable. The challenge facing those responsible for Greece's budget will not be made any easier by the fact that international capital markets are functioning well and are demanding high risk premiums for Greek government bonds, which nevertheless remain easy to sell. A collective bond issue by E.U. states in Greece's name would actually bring some relief but also effectively camouflage the real situation—and amount to direct financial aid through the back door. It would also sidestep the sanctions of the Stability and Growth Pact, which urgently needs an upgrade, and the sanctions automatically imposed by the capital markets in cases of fiscal misconduct. Compared with 10-year German government bonds, the spread on Greek government securities temporarily reached 370 basis points in January, its highest level since the introduction of the euro. This year Greece needs to borrow at least another 54 billion euros in order to be able to service its debt.

The Greeks did not ask for direct aid. Greece's senior debt manager, Petros Christodoulou, emphasized, "We are doing this on our own; we do not need the help of the E.U."[2] The only intervention Greece requested, and was granted at the E.U. summit in late March, was the promise of support as a way of reassuring financial markets so that risk premiums do not continue to rise and interest rates are contained. This might sound harmless but it actually means that Greece's partners in the euro are making themselves accomplices in an effort to avoid punishment by the financial markets. Moreover, the bilateral loans that will be supplemented "if necessary" by an IMF aid package for Greece in fact represent nothing less than a contravention of the contractual basis of the monetary union, the "no bailout clause" in article 125 of the Treaty on the Functioning of the European Union.

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In order at least superficially to undo this grave sin, the German chancellor Angela Merkel now insists on stricter adherence to the original Stability and Growth Pact, which had been successively weakened over recent years. However, experience shows us that she is unlikely to get her way. And thus the latest resolutions are merely the logical continuation of the either dangerously naïve presumptuous or simply negligent visions of yore. To quote Schiller, "This is the curse of every evil deed, that propagating still, it brings forth evil."

This brings us to the real question of whether the whole project of monetary union did not have a clubfoot from the beginning and whether there was any awareness of this problem. Again, the answer is yes. The architects were aware of this and simply accepted it. Europe donned an economic corset without really knowing if it was laced too tightly. It was clear to economists and politi-

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[2] *Frankfurter Allgemeine Zeitung* March 20, 2010, p. 23

cians from the beginning that monetary union represented a risk. The reason is simple: when everyone has the same money, exchange rates disappear. The fact that this would mean savings for consumers and firms in terms of exchange costs and accelerated economic integration was a powerful argument for the euro at the time, and in general terms this hope was born out. However, when exchange rates disappear so too does an automatic buffer between national economies. Moreover, it means countries can no longer make use of a popular albeit precarious instrument of financial policy. In 1991 the American economist Martin Feldstein warned that the loss of national independence regarding monetary policy and the potential for exchange-rate flexibility in Europe could have negative consequences and that these could far outweigh the advantages in terms of trade facilitation.[3]

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The Right to Create Money

What are the adaptation mechanisms operating between different countries in the normal case, i.e. without monetary union? When a national economy suffers severe problems this is reflected directly in currency markets. Demand for the national currency decreases and as a result the currency commands a lower price; the price of a currency is its exchange rate. However, the currency's weakness also increases competitiveness. Foreigners can now buy goods produced in the country concerned more cheaply due to the favorable exchange rate. This in turn provides an impulse for the real economy. It is precisely because they can vary that flexible exchange rates provide an effective buffer that functions automatically. As long as there are differences between national economies, whether based on the real economy or conceptual approaches to economic policy, flexible exchange rates constitute the tool of choice.

In the case of a fixed-exchange arrangement like the European Monetary System prior to the introduction of the euro, such an effect can be artificially achieved by altering exchange rate parity, meaning that a country devalues its currency by decree and thereby makes its products cheaper for foreign purchasers. However, such voluntaristic manipulation of parities can be the cause of political headaches. First, devaluation for external economic reasons is not without consequences for income distribution within a country and for its internal dynamics. Ultimately this means initially permitting the development of unproductive structures within the country and correcting them retrospectively (only) on the export front. Second, it is not easy to draw the line between an acceptable correction of national problems and a "beggar thy neighbor" approach to foreign competition. However, fixed exchange rates are per se a voluntaristic strategy and sometimes devaluation can win a country time to make real reforms.

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[3] Martin Feldstein, "Wirtschaftliche und politische Aspekte der europäischen Währungsunion," *Monatsberichte der Deutschen Bundesbank*, 1991, vol. 42., no. 10, p. 12.

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In a monetary union this kind of—automatic or instrumentalized—adaptive mechanisms using exchange rates that are flexible or fixed but in any case negotiable do not exist. If, for example, a country's productivity is too low or labor costs are too high, this is no longer automatically corrected via the external value of the currency. Such a country accumulates a current-account deficit more quickly than would otherwise be the case and unemployment becomes entrenched. If adaptation is no longer possible in terms of price, then it must proceed in terms of quantity—a particularly painful process for the country's citizens.

In such a situation it is tempting for the government to take on more debt so that it can support the economy through public expenditure. This can easily give rise to a debt spiral. Moreover, in a monetary union it is no longer possible to "inflate away" these debts unilaterally, a strategy that may seem outrageous due to the resulting distortion of allocation and distribution but that has become an established and popular tool at the level of practical politics. Olaf Sievert, the former chairman of the German Council of Economic Experts, once bitterly described the history of single-state sovereignty over the monetary system as the "checkered history of the improper use of the right to create money."[4] In a monetary union this danger is systematically reduced. A common central bank means that it is no longer possible to tailor monetary and interest policies to suit the needs of a single national economy.

This may be problematic where there is a lack of convergence, but it does ensure that the "improper use of the right to create money" is curtailed, something that is in the interest of all countries. And it is certainly no longer pos-

[4] "Geld, das man nicht selbst herstellen kann," *Frankfurter Allgemeine Zeitung* September 26, 1992, p. 13.

sible to simply free up liquidity in response to the economic situation of an individual country. In short, every country that joins a monetary union has to be certain that it can do without exchange-rate flexibility and the sweet but ultimately deadly poison of the bank-note printer. Such certainty can only be even vaguely realistic once there are no longer differences between individual countries that need to be balanced out.

Economic Lockstep

In a monetary union the competition between countries as business locations is more honest because it is not influenced by exchange-rate variation and does not allow for manipulation using monetary policy. But this means competition is also tougher. In fact it is this characteristic that formed the actual rationale behind European economic and monetary union, even if this is sometimes forgotten. The aim was to strengthen competition within Europe and compel its member states to adopt policies that ensured stability so that they could collectively realize new dimensions of the division of labor, effectiveness, and prosperity. At the time Sievert sounded optimistic: "The European Monetary Union will discipline the spending policies of its member states and intensify competition in the areas of taxation and fiscal policy." He did not see the Maastricht criteria as decisive in this sense, arguing that monetary union "will primarily achieve this by itself."[5]

Why then were the compliance rules introduced? The five criteria initially served the goal of ensuring at least a minimum level of convergence. Politicians had no illusions about the fact that too much deviation in terms of efficiency and policy discipline would lead to serious dislocations in the real economy in the absence of variable exchange rates and differentiated monetary policies.

Two of these criteria, the 3 percent upper limit on new borrowing and the 60 percent upper limit on national debt, were subsequently adopted into the Stability and Growth Pact initiated by Germany as permanent codes of conduct aimed at ensuring fiscal discipline. It was hoped that they would prevent partners from drifting apart again in economic terms. The risk was clear: even if the Maastricht criteria—given countries did not merely pretend to meet them—produced the desired discipline, this would not guarantee countries remained in step at the level of the real economy. Subsequent developments proved this fear to be well-founded. For most of the southern countries the single base rate of interest set by the ECB was too low. A unitary monetary policy that was ill-adapted to their situation created a property bubble and allowed countries to live "beyond their means." Or as economics professor Wilhelm Nölling, one of the "upright four" who went before the German Constitutional Court to protest the introduction of the single currency, put it, "While we have saved, Greece, Italy, Spain, Portugal, and Ireland have preferred to live on credit and ignored the need to reform."[6]

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[5] Olaf Sievert, "Geld, das man nicht selbst herstellen kann."
[6] *Focus Money* 3, 2010.

Furthermore, there has certainly been no political convergence in terms of the fundamental economic convictions of the member states. Leaving aside the fact that changing political majorities generally aspire to put their own stamp on economic policy anyhow, the tradition of stability in the south has always been weaker than in the north. Europe has not demonstrated a unified economic will in the past and in this respect it has not changed. The fact that the partner countries reached a consensus on the introduction of the euro was not the result of a shared outlook, least of all an economic one. This consensus was largely politically motivated. Germany in particular probably felt compelled to abandon the deutschmark in light of the support it had received from its European partners for German reunification. The result was a willful disregard for the fact that bringing Europe together in a way that flew in the face of all economic reason would ultimately sow seeds of contention.

Money Cannot Buy Political Union

Given the need to somehow hold together an amalgamation based on political vision that was unsustainable in terms of economic policy and subject to formidable centrifugal economic forces, there were only two possibilities. One logical possibility was and remains the "communalization" of all policies of the European Union. In short: political union. This would of course mean losing the advantage emphasized by Olaf Sievert of an exclusively monetary union that drives a stabilizing wedge between a (centralized) money supply and the interventionist will of (decentralized) policy-making. Moreover, such a union is compatible neither with partner states' claims to sovereignty nor with their diverse conceptions of regulation. Substantive differences cannot simply be made to disappear by applying the crowbar of uniformity. As Josef Joffe, joint editor of German weekly *Die Zeit,* argued, monetary union is not a covert abbreviation for political union. "Money is not a supranational corset that can hold together what aspires to be apart."[7] We still see pressure to move in the direction of a closer political union today. It is evident in the efforts to harmonize the union and regular calls by the French president Nicolas Sarkozy and the president of the Euro Group Jean-Claude Juncker for an independent European economic government.

Bringing Europe together in a way that flew in the face of all economic reason was bound to sow seeds of contention.

The second possibility consisted in firmly corseting the European club. This was the hope of the Stability and Growth Pact, which permanently codified in the two fiscal Maastricht criteria. The pact, which was supposed to apply sanctions in the form of financial penalties when rules were broken, has progressively been watered down year by year. It is now ineffective. The "fundamental condition that each member of the monetary union must be accountable for its public debt that cannot be manipulated in real terms"[8] no longer applies. It has been robbed of its bite.

[7] Hans-Ulrich Jörges (ed.), *Der Kampf um den Euro*,1997, p. 211.
[8] Olaf Sievert, "Geld, das man nicht selbst herstellen kann."

And why? Because from the outset there was no real consensus on the need for stability and because the pact was badly constructed in the first place. Allowing heads of state and government to decide on how effective it will be is like trusting the cat to keep the cream. The pact would only have had bite if politicians had dared to take the step they took with the European Central Bank: placing decision-making power in the hands of an independent body. No one should therefore be surprised that a dysfunctional Stability and Growth Pact has missed its target and as a consequence placed the euro zone in its extremely precarious current situation.

Not Made For Crises

With his characteristic pathos, then-chancellor Helmut Kohl regarded the introduction of the euro as a question of war and peace. But it is doubtful that the absence of military conflict within the European Economic and Monetary Union has anything to do with the euro. The view that monetary union has actually increased solidarity among nations is difficult to maintain when one hears what some Greeks are currently saying about Germany. At the beginning of March, the deputy prime minister Theodoros Pangalos rejected all criticism of his government by referring to German crimes during the Nazi period, including the German theft of Greek gold from the central bank. This was historically inaccurate—the British took the gold abroad to keep it safe and later returned it to Greece. Nevertheless, the comments opened Pandora's Box. Soon there was talk of reparations for the occupation of the country between 1941 and 1944 and of repayment of a loan coerced from Greece in 1942. It is true that all these questions need to be dealt with. But whether Greece should be using them as scare tactics to induce support from the European Union's biggest net contributor is more than a tactical question.

This kind of scrapping within Europe could continue and even intensify, perhaps involving other constellations. Friendship stops when money is involved. We do not necessarily have to share the view of Wilhelm Hankel, one of the four plaintiffs against the euro in 1997, who predicted that the euro would prove to be Europe's downfall. But if this happens, it would be the tragic price of the hubris with which Europe's political visionaries once flouted the emphatic warnings of economists. We now know that Hankel was right when he warned that the euro was not made for crises. It was, he argued, a "mousetrap currency"[9] that one can walk into quite easily, but can only leave, if at all, with painful losses. Greece is the first mouse caught. Perhaps all the euro states may find themselves trapped, too.

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[9] Hans-Ulrich Jörges (ed.), *Der Kampf um den Euro*.