



Greece's Debt Crisis and the Contagion of the Euro Zone
An Interim Balance Sheet of Ambitions and Results

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Summary

Als der Europäische Rat am 21. Juli 2011 in Brüssel zusammentrat, wollten die Staats- und Regierungschefs nicht nur Griechenland vor dem drohenden Bankrott retten, sondern den Euro-Raum als Ganzes stabilisieren. Kaum zwei Wochen nach dem Treffen schwanden aber schon wieder die Hoffnungen. Die Finanzmärkte reagierten erneut skeptisch und verlangten von den Schuldenstaaten wieder deutlich höhere Renditen. Neben Griechenland sind mittlerweile auch Portugal, Irland, Spanien und Italien betroffen. Auch Zypern muss bangen, hält es doch in großem Umfang Staatsanleihen von Griechenland. Die massive Verschuldung Griechenlands stellt sicher das Hauptproblem dar. Erst wenn das griechische Problem gelöst ist, wird das Vertrauen der Finanzmärkte zurückkehren. Der vorliegende Artikel geht auf zwei Fragen ein: Erstens, ist der Stabilitäts- und Wachstumspakt mittlerweile in einer Weise geschärft worden, dass eine übermäßige Verschuldung wirksam unterbunden werden kann? Zweitens, da Griechenland und andere Staaten weitere Finanzhilfe benötigen, stellt sich die Frage welche Variante die am wenigsten riskante darstellt. Es zeigt sich, dass alle Optionen erhebliche Risiken mit sich bringen. Es bleibt die Lehre: Wer sich übermäßig verschuldet, die Regeln der Europäischen Währungsunion missachtet und den Haftungsausschluss gemäß Maastricht-Vertrag ignoriert, der liefert sich den internationalen Finanzmärkten aus und ermutigt die Spekulation. Wenn Staaten zu groß sind, um sie mit ihren Schuldenproblemen allein zu lassen, und wenn eine Implosion der Euro-Zone droht, dann werden halbwegs solide wirtschaftende Euro-Staaten erpressbar und gibt es frisches Geld auch dann, wenn Reformen in den Schuldenstaaten unzulänglich sind. Die Politik setzt in dieser Situation vor allem darauf, nach der evident gewordenen Verschuldungskrise Griechenlands eine Ansteckung weiterer Länder im Euro-Raum zu vermeiden.

Fiscal imbalances in Greece as core problem of the euro-zone

When the heads of state and government of the euro-area convened in Brussels on 21 July 2011 they intended first of all to prevent Greece from becoming bankrupt; secondly the intention was to stabilise the euro-zone as a whole. As is evident from Table 1, Portugal, Ireland, Spain and Italy, but also Cyprus are under pressure from the financial markets as they are highly indebted. Cyprus is included in this group as its banks had bought government bonds from Greece amounting to €31 billion. Only two weeks after the Brussels convention, the hope that the markets would trust the decisions taken by policy-makers in Brussels was dashed as higher interest rates were demanded from Spain and Italy.

Table 1

Deficit and debt of selected Euro states 2010 (percentage of GDP)¹

	Greece	Ireland	Spain	Portugal	Italy	Cyprus	Euro-zone-17
Deficit	10,5	32,4	9,2	9,1	4,6	5,3	6,0
Debt	142,8	96,2	60,1	93,0	119,0	60,8	85,1

Massive fiscal imbalances in Greece are considered to be the main problem of actual turbulences in the euro-zone. Other euro members are confronted with excessive deficits and debts too. But confidence of financial markets towards heavily indebted countries will not return before the Greek problem is solved. This article focuses on two aspects: First, as *political* surveillance of fiscal stability by the Stability and Growth Pact proved to be insufficient in the past to say the least the question is whether this mechanism has been improved. Second, as Greece and other states depend on new packages of financial assistance various options are under discussion. Taking *economic* implications into account and acknowledging that all options are extremely risky it is not astonishing that authorities seem to be at their wits' end to design a long term strategy.

When Greek bonds were downgraded to “junk” by rating agencies at the end of April 2010, the floodgates opened. Fears of contagion prompted investors to offload their Portuguese and Spanish bonds as well. On 10 May, euro-zone governments, the EU and the International Monetary Fund (IMF) granted a package of financing for Greece amounting to €110 billion and a further €750 billion for the euro-zone as a whole. In both Greece and Portugal, the

problems were the result of debt and a lack of competitiveness. In Ireland and Spain, an overheated economy caused a real estate bubble to burst; their governments responded by guaranteeing bank debt. In November 2010, Ireland requested loans from the €750 billion European Financial Stability Facility (EFSF) set up to safeguard financial stability in Europe, with Portugal following suit in May 2011.

Financial assistance for indebted euro partners – what does the Maastricht Treaty say?

Under the Maastricht Treaty, every euro-zone country must adhere to the principles of sound financial and budgetary management and cannot expect its partners to take on liability for its debts. This “no bail-out” clause is enshrined in Article 125 of the Treaty on the Functioning of the European Union (TFEU). Article 123 TFEU prohibits the European Central Bank from granting overdraft facilities to Member States. The Treaty requires the Commission to monitor the development of the budgetary situation in the Member States.

The fact that an agreement was reached in Maastricht to transfer monetary but not economic policy jurisdiction to the supranational level was primarily due to the conflicting positions of France and Germany. Germany insisted that the ECB should be politically independent and maintain a commitment to price stability. France responded by demanding common economic governance. However, France’s main concern was not to introduce supranational steering of economic policy, but to subject the ECB to the political influence of the governments of the euro-zone countries. As these countries no longer had recourse to the tool of “external” devaluation of their national currencies in order to improve their competitiveness vis-à-vis trade partners, their only remaining option was to resort to “internal” devaluation through adequate wage and price flexibility.

In terms of compliance with the Treaties, however, the euro-zone’s granting of financial assistance is on thin ice, as is apparent from the provisions of the loan agreement with Greece. This refers to bilateral “pooled” loans from the euro-zone countries, not to loans from the euro-area as a whole.² To avoid any conflict with the “no bail-out” clause, the legal basis for the granting of these bilateral loans and credits is Article 122 TFEU, which states that “in a spirit of solidarity”, where a Member State is in difficulties caused by “natural disasters or exceptional occurrences” beyond its control, the Union may grant financial assistance to the

Member State concerned. Referring to the Greek debt crisis in these terms is not convincing, as the European Commission itself confirmed in February 2010.³

A design flaw in the Maastricht Treaty?

With the benefit of hindsight, it is clear that at the time of the founding of Monetary Union, the risks were underestimated. When the Maastricht Treaty was concluded, the risk that the introduction of the euro could act like “sugar-coated poison” on less stability-conscious countries and prompt them to take on more debt was also underestimated. Greece is a good example: even though the international financial markets did not regard the country as particularly creditworthy, Greece had to offer 10.6% yields on 10-year bonds in 1996, falling to just 4.6% in 2008.⁴ Investors relied on the fact that if problems arose, the euro-zone would have no option but to bail out Greece, which mitigated their investment risk.

Macroeconomic divergences have had more of a negative impact in the euro-zone than was assumed when the Maastricht Treaty was signed. The monitoring mechanisms built into the Maastricht Treaty rely on the euro-zone countries’ supplying reliable macroeconomic data. If false data are reported to the European statistical agency Eurostat, however, as happened with Greece, the Stability Pact finds itself on increasingly shaky ground. The Commission’s attempts to verify the statistics in Greece itself were thwarted by the euro-zone countries, however.⁵ The inaction lasted for far too long, despite widespread concerns about compliance with the Maastricht criteria.⁶ The sanctions envisaged in the Stability and Growth Pact are ineffective if euro-zone countries collectively violate the debt ceilings. In 2009, only three of the 16 euro-zone countries managed to keep their deficits within permissible limits.

Although Germany was keen to ensure, with the Stability and Growth Pact, that the euro-zone countries adhered to sound budgetary management principles, Germany’s own actions contributed to the softening of the Pact. In 2005, the Brussels European Council amended the Stability Pact and eased the criteria for defining what constitutes an “excessive deficit”.⁷ And lastly, the rating agencies also deserve criticism for failing to fulfil their responsibilities, particularly for their considerable delay in warning of the risks posed by euro countries with a very high level of debt.⁸

The reform efforts to date

As existing instruments and procedures have not led to a satisfactory reduction of public debt and have failed to tackle macroeconomic imbalances, politicians are now focusing on reform. The Commission therefore proposed drastic measures aimed at *tightening up the Stability Pact*. Under these proposals, the task of deciding on a deficit procedure would be transferred from the Council to the European Commission. The deficit procedure could then only be blocked by the Council on the basis of a “reverse majority rule”, which means that Commission recommendations would be adopted unless a qualified majority of Member States in the Council votes against, within 10 days.⁹ Sanctions could also be triggered more automatically and at a much earlier stage than at present. In budgetary surveillance, a far more prominent role would be given to levels of debt as well as to the deficit. Annual growth of public expenditure should not exceed a prudent medium-term rate of growth of GDP.¹⁰ President Herman Van Rompuy’s economic governance task force signalled to the Commission where the limits lie, however: it accepted the Commission’s recommendations on sanctions, with the Council to proceed on the basis of the reverse majority rule, but made it clear that responsibility for deciding on the crucial question of whether a deficit procedure should be opened at all must remain with the Council.¹¹ By way of justification, it argued that the Treaties require that this be a Council decision. The alternative – that this competence should pass from the Council to the Commission as part of a Treaty amendment that is due anyway – was rejected on the grounds that Member States wish to retain the right of final decision. President Van Rompuy’s report was adopted by the European Council on 28-29 October 2010.¹²

By contrast, the German-French summit in October 2010 paved the way for agreement on establishing a *permanent crisis mechanism*. German Chancellor Angela Merkel was adamant that there should be no further recourse to Article 122 TFEU. Instead, following a Treaty amendment, a European Stability Mechanism (ESM) should be set up in the euro-area as of 1 January 2013, with Article 125 (“no bail-outs”) remaining in force unchanged and the Stability Mechanism being designed to safeguard the financial stability of “the euro-area as a whole”.¹³ Attention also focused for the first time on case by case participation of private sector creditors in cases of excessive debt.

There is still a clash of opinions over the “preventive arm” of the Stability Pact, which entails *closer coordination of economic policies* under Article 121 TFEU. It is still unclear what is meant by France’s call for “economic governance”.¹⁴ If such economic governance is supposed to entail supranational regulation of revenue and expenditure, this would lead to a loss of sovereignty which would be unacceptable to France itself. If it means coordinating wage trends, this would conflict with the right to free collective bargaining and the fragmentation of wage negotiations. If it is about limiting current account balances, this would be tantamount to an intervention in national budgetary sovereignty.¹⁵

In advance of the European Council on 4 February 2011, Chancellor Merkel unveiled a new “Pact for Competitiveness”, a six-point programme for more competitiveness, to be implemented nationally within 12 months: abolition of wage/salary indexation systems; mutual recognition agreement on education diplomas and vocational qualifications; the creation of a common assessment basis for corporate income tax; adjustment of the pension system to demographic development; obligation for all Member States to inscribe the debt alert mechanism into their respective constitutions; and establishment of a national crisis management regime for banks. In all these areas, the EU should orient itself according to the respective best practice. The programme defines quantifiable indicators for national economies’ competitiveness (real labour costs, stability of public finance (wages of public-sector workers) and investments in research, etc.).¹⁶ New competences for Europe are ruled out.¹⁷ The Pact has little binding force and does not provide for any sanctions.¹⁸

There was some convergence of positions between Berlin and Paris: the Treaty amendment to introduce a permanent crisis mechanism, to which Germany attaches such importance, gained the support of France as well. In exchange, Germany jettisoned its idea to withdraw voting rights from transgressor Member States and also dropped its support for automatic sanctions. The two countries also moved closer on the issue of maintaining the “no bail-out” clause, as well as on the participation of private sector creditors and the more prominent role given to levels of debt. With her Pact for Competitiveness, the Chancellor has moved a step closer to the idea of economic governance advocated by France. The European Council meeting on 24-25 March 2011 agreed a package of reforms for Monetary Union, although the adoption of the legal instruments on the Stability Pact and the coordination of economic policy are still pending. The main priority, for the heads of state and government, was to impress the financial markets with a solid package of measures and put an end to speculative overheating.

To sum up: surveillance of fiscal stability will be strengthened by a reformed Stability and Growth Pact but a major problem will still exist in future. It will be the Council which decides at last. If the situation will be the same as it was in the past when most of the euro members ignored limits of deficit and debt then once again “sinners will sentence sinners”. Although economic governance was stressed again and again it became evident that real progress is hard to deliver. A loss of national sovereignty is not accepted even by those who plead for this model. The same must be said with respect to the “Pact for Competitiveness”. Intentions are made clear but sanctions missing.

Failed aspirations and critical questions to future options

As we can see some progress was made with respect to the future governance of the euro-zone, but the hope was dashed that Greece would be able to refinance its debt by private investors in 2013. That was the intention when euro partners concluded the package for financial assistance in May 2010. In June 2011 it became obvious that alternative solutions were needed. A debate started what would be the best option to overcome the Greek debt crisis and how to avoid that the whole euro-zone could be infected. Five alternatives are under discussion: Following the first option Greece would leave the euro-zone and return to the drachma as national currency. The second solution would be a (hard) debt restructuring as it was done e.g. in the case of Russia in 2000, Argentina in 2005 or Ukraine in 2000. A “soft” debt restructuring as the third option would rely on the reduction of interest rates and/or an extension of the terms of loans given to Greece. Common loans of the euro-zone, so called “eurobonds”, which would offer lower interest rates to heavily indebted countries, constitute the fourth alternative. And finally, the fifth option would be to assist countries like Greece with fresh money.

To provide a more systematic analysis of what are the chances and risks of the options mentioned ten questions must be answered:

1. What will be the reaction of *rating agencies* concerning the alternatives? These agencies have been criticized heavily as they had given positive credit ratings to institutions like the Lehman bank which led into the global financial crisis of 2008. Another criticism has

been mentioned above: the agencies gave a warning towards the financial problems of Greece too late. And whereas it is obvious that the agencies underestimate the critical debt situation of the US they downgraded Portugal in July 2011 although the Government followed a stabilisation plan which was demanded from the euro-zone and the IMF. On the other hand it cannot be ignored that investors rely on these rating agencies when they decide where to invest their money. It is a matter of fact that policy makers have to take into account the rating agencies' assessments when decisions are taken.

2. A second question concerns the reaction of the *financial markets*. Will they provide acceptable conditions with respect to interest rates and credit default swaps when one of the alternative options is chosen? As long as partners provide financial assistance to highly indebted states in the euro-zone banks and other investors realize high profits. That is why politicians demand a substantial contribution from the private sector when new financial packages will be granted for Greece and other candidates. That however has initiated critical reactions as some rating agencies have declared that they will downgrade debt states in such a situation near to "default" as private investors have no chance to get back the whole investment.
3. What are the consequences for *domestic financial institutions*? Will Greek banks e.g. have a chance to survive or will savers transfer their money abroad, so that banks will no longer be able to provide credits to enterprises in Greece? In June 2011 Greek banks had given to the states credits amounting to €45 billion. Greek investment and pension funds were engaged with €29 billion.¹⁹ The banks' core capital is estimated to €47 billion.
4. What are the consequences for *creditor banks*? Do they suffer from substantial losses when borrowing states do not fulfil their obligations? To answer the question it is important to know which banks with which amount of money are engaged in Greece. Two observations can be made: First, banks of the euro-zone have reduced their engagement and second, main creditors come from Germany and France actually. If the risks of banks are estimated it is important to know which share of their whole capital the credits given to Greece have. Based on data from the Bank for International Settlements the value of credits given by banks to Greece amounted to the following figures (see table 2).

Table 2

Credits given to Greece (in billion US dollar)²⁰

	Germany	France	Italy	Rest of euro-zone	United Kingdom	US
March 2010	23.1	27.0	3.3	22.9	3.6	5.4
End of 2010	22.7	15.0	2.3	7.7	3.4	1.5

5. Every alternative option has to answer the question what the consequences are for the *stabilisation of the country* with an excessive debt. Will revenue of the state budget increase and expenditure decrease so that the deficit will be reduced in a shorter and the debt in a longer time period? Financial assistance which was provided to Greece in May 2010 was dependent on strict conditions set by the euro-zone and the IMF. As a consequence Greece reduced its deficit which was equivalent to €36.2 billion in 2009 by €14.2 billion in 2010. To give an impression of the Greek effort: If Germany would have intended to reduce its deficit to the same amount the country would have to save €143 billion. Recent experiences with Greece demonstrated once again that governments can reduce expenditure by cutting wages and releasing employees more easily than increasing revenues: From 2009 to 2010 expenditure in Greece has been cut by 6.4% whereas revenue increased by 4.8% only.²¹ A substantial reform which secures that taxes from self employed people are collected in a sufficient manner is a still pending task for Greek authorities.
6. As states try to avoid political costs it is inevitable that the reduction of excessive deficits and the implementation of stabilization programmes are put under *surveillance*. Two alternatives are at hand: First, surveillance can be carried out by *political* mechanisms. When the European Monetary Union (EMU) was created the Maastricht Treaty established the convergence criteria to construct an optimum currency area. Later in 1997 the Stabilisation and Growth Pact was concluded to ensure that member states of the EMU would keep in line with the criteria. As it was explained above the effectiveness of this political form of control had limited effects as nearly all states ignored the limits of deficit and debt. Second, control can be accomplished by the *markets* in a very simple manner: Markets can sanction states with excessive deficits and debts by demanding higher interest rates and credit default swaps. Under such conditions governments face severe problems and have to follow a strict course of stabilization to calm markets down and to enjoy

better conditions for credits. This argument however is convincing only if perfect markets are given and rating agencies are sending correct signals (see above).

7. If stabilization programmes of heavily indebted countries concentrate on expenditure reduction and revenue increase exclusively a major problem will not be tackled: These states have to strengthen *economic growth* and improve *competitiveness*. The more an economy grows the smaller the debt as a percentage of the GDP will become and the easier the access to fresh money will be. Under such circumstances countries can outgrow of deficit and debt.
8. As Greece is not the only country with an excessive deficit the risk is given that other states in the euro-zone like Portugal, Ireland, or Spain could be infected. So, alternative options to solve the problems of Greece must intend to avoid *contagion*. That could happen when investors pull out of countries or raise interest rates significantly as they perceive measures taken to rescue Greece too negative.
9. *Financial costs* of every rescue package cannot be neglected. Nearly every country has been forced to consolidate public finances and to cut social expenditure. Under such circumstances it is a sensitive issue when financial assistance is provided to countries which ignored the principles of solid housekeeping. Do we have to tighten our belts to help other countries? This question comes up immediately in a euro-zone where individual responsibility for the budget of the own state is the leading principle.
10. And finally *political costs* might occur when dissatisfaction with rescue measures lead to growing nationalist tendencies and to national animosity. That is a situation where even anti-integrationist movements could gain influence.

Alternative options and their risks

The first scenario, a country *leaves the euro-zone*, has to take into account that no country can be forced to do that as the treaties of the European Union do not foresee such an alternative. Positive implications of such a (more theoretical) scenario would be (see figure 1): As far as prices are concerned the country would become more competitive. This would have a positive

impact on growth rates and finally lead to more competitiveness. On the other hand the country's debt still would be signed in euro. With a devaluating national currency the country would not be in a position to pay its dues. Under such circumstances the partners in the euro-zone could feel obliged to take over the debts. What would be the foreseeable reaction of rating agencies when a country like Greece would step out of the euro-zone? The agencies would assume that a state cannot longer trust in "solidarity" of the euro-zone and therefore warn to invest in Greece. Debt conditions would deteriorate.

Figure 1: Alternative Options and their implications

	rating agencies	markets	domestic banks	creditor banks	consolidation	surveillance	growth	contagion	costs
leaving the euro-zone	?	?		?	?				
debt restructuring				?			?		
soft restructuring	?	?		?			?	?	?
euro bonds							?		
fresh money	?	?					?		

positive | ? = unclear | **negative**

Even countries which are relatively well performing in the euro-zone could be affected as they have to pay higher interest rates because mutual assistance in the euro-zone is put into doubt. Banks in countries leaving the euro-zone would have no chance to survive as clients would deplete their accounts immediately. Creditor banks on the other hand would face problems if their credits would not be repaid. Whether a state follows a strict policy of consolidation is a critical question: If the government wants to benefit from acceptable conditions of the financial markets it had to stabilize its economy. But if policy makers gain for some form of debt relief the will could be weakened to follow a strict course of stabilization as governments try to avoid political costs. Only in the case that governments follow the first way the financial markets would take the role of surveillance. Although competitiveness can be improved under such conditions by devaluation it must be anticipated

that depression would dominate for a long time. And contagion to other highly indebted countries would be probable.

The second option, a *debt restructuring*, is the favourite among economists.²² What makes this alternative attractive? One important argument is that private creditors benefit from the financial crisis of euro members as they realised high interest rates which are guaranteed by financial assistance of the euro-zone. In the case of a debt restructuring not only the tax payers but also the creditors would have to take over some costs of financial assistance for the heavily indebted states. For creditors a debt restructuring implies that they have to charge off at least parts of their credits. In such a case rating agencies would declare immediately a “default”, consequently a country like Greece would no longer have access to the financial markets. Banks in Greece would go bankrupt as the exodus of capital would be the consequence. That is why partners from the euro-zone might think about financial assistance for these banks. As economists argue it would be less expensive to save Greek banks than to offer a guarantee for 70% of Greece’s debt.²³ To which extent creditor banks would face severe problems depends from the level of their financial investment in the country in question. If the capital invested in Greece amounted to a significant share of the bank’s capital resources a collapse could be the consequence and the demand for state aid could be heard once again.²⁴ Under such conditions the control over stabilization programs would be executed by markets mainly. Without a convincing programme of consolidation the financial markets would be closed for states after a debt restructuring. A longer time of depression is unavoidable and can be shortened by drastic reforms only. The problem of contagion would be significant due to the reaction of rating agencies and financial markets which mistrust other heavily indebted states and anticipate a debt restructuring here also.

Whereas economists prefer a “hard” restructuring many prominent policy makers are in favour of a “*soft restructuring*”.²⁵ Often the model of the “Vienna Initiative” is recalled when in 2009 states from Central and East Europe had to repay loans and when the credit period was extended. Another alternative would be the reduction of interest rates. Both forms are interpreted as a “contribution from the private sector”²⁶ – but with less negative effects to banks and investors. To some extent the euro partners have followed already the method of a soft restructuring when they extended the credit period for Greece from 3 to 7 ½ years and reduced the interest rate by 1 percentage point on 17 June 2011. If a soft restructuring would be followed to meet the fiscal problems in Greece and other euro states then the rating

agencies' reaction would be of major importance. The agency "Fitch" has given already a negative signal when it declared that it would devalue the country affected to the pre-stage of "default" when the "Vienna Initiative" were chosen as an option. Therefore the crucial question is: Will rating agencies come to negative assessments and will financial markets follow their estimations? If yes the soft restructuring would become a hard one. If not the soft restructuring had advantages especially as the risk of a contagion of other heavily indebted states would be reduced. On the other hand if the restructuring would be a soft one this could become very critical for domestic banks as they hold big parts of their states' debts. When creditor banks agree to a soft restructuring it is highly probable that they demand some sort of "deal": extended credit periods only when state guarantees for the security of the loans are provided. The pressure for severe programs of consolidation would be weaker than it would be in the case of a hard restructuring. The surveillance of such programs would be a political one with all the weaknesses mentioned above. Whether growth and competitiveness can be improved that depends from the course followed the government of the indebted state. The pressure to do it is limited as long as the perception prevails that getting fresh money is no problem.

The interest rates demanded from countries in the euro-zone differ significantly. Germany e.g. had to pay about 3% for a ten year loan in July 2011 whereas markets demanded from Greece more than 16%, from Ireland and Portugal more than 12% and from Spain nearly 6%.²⁷ That led to the idea whether it wouldn't be favourable when countries enjoying an excellent rating would take loans with favourable conditions and transfer these loans to countries in the euro-zone from which markets demand higher interest rates. That is the basic idea of "*euro bonds*".²⁸ What are chances and risks of this alternative? One risk will be the perspective that rating agencies would downgrade the donor states as investments here are assessed to be more risky. Financial markets could follow and demand higher interest rates as they feel insecurity when euro bonds are transferred to countries with lower credit standing. Negative effects could harm donor states but not the banks. Domestic as well as creditor banks had no reason to assess their investments in heavily indebted states as insecure. Under such conditions the pressure to follow a strict course of stabilization and consolidation would be weakened. The lever that markets exercise control over these programs would be abolished. Improvement of growth and competitiveness would depend totally on the course of governments. The positive news however is that contagion to other massively indebted states would be restricted. Contagion would be a problem for countries with a positive rating.

The last option is “*fresh money*” for those countries which have no chance of re-financing their debt by the financial markets at acceptable conditions. When euro partners decided in May 2010 to provide financial assistance to Greece amounting to €110 billion the expectation was that Greece would be able to return to the markets not later than 2013. As such a perspective has become improbably a second financial package came up. In such a case the rating agencies’ response would be more or less neutral. They would not see any reason to downgrade or upgrade a country like Greece. The same should be anticipated from the markets’ reaction. Interest rates would be kept on nearly the same – high – level. Perspectives of domestic as well as creditor banks should be positive as they do not have to be afraid of any sort of “haircut”. It is not very likely that a government follows a strict course of consolidation if it can avoid it. As the control is carried out by political mechanisms exclusively bad experiences with the Growth and Stability Pact rise up once again. The chances for improving growth and competitiveness depend on the decisions taken by the government which enjoys financial assistance once again. Assessments with respect to contagion are ambivalent: as far as the markets are concerned they do not have convincing reasons to increase interest rates for other highly indebted countries. On the other hand these countries have good reasons to ask for an extension of financial assistance for them too. A permanent “transfer union” would be unavoidable.

Having discussed alternative options the questions arises: What is the price of these alternatives in financial terms? It is evident that such a calculation must be tentative and rough. Asked to calculate the costs for Germany two scholars came to the result that in the case of Greece the financial burden could range from €19.2 to 56.1 billion. The lower amount would be due if privatisation in Greece would progress and the country serves its debts in 2015. The higher amount would be the consequence if Greece does not pay its debts so that a debt restructuring would be the consequence.²⁹ As mentioned above political costs have to be taken into account too. In the case of Greece and other highly indebted countries it might be a question of time when people throw governments out of office and political instability is the consequence. On the other hand people in the “donor countries” become more and more critical over financial assistance to the favour of highly indebted countries. Governments can come under pressure, animosities increase and lead into nationalist and anti-integrations movements.

Interim balance

A first conclusion is at hand: who slides into excessive debt, who violates the criteria set by the Maastricht Treaty and who ignores the “no bail-out” rule, extradites himself to the international financial markets and even encourages speculation. Under such conditions creditors become victims of blackmailing: If governments are too big to fail and if an implosion of the whole euro-zone is suspected fresh money is at hand – even if reforms in debt countries are insufficient. That is why the political opposition in Greece shows no preparedness to unite in a national consensus to overcome the crisis and to take political costs too.

A second conclusion can be drawn: all alternatives discussed above have severe negative implications. A “silver bullet” out of the crisis is not in sight. So, a last question shall be answered: Which option is favourable to whom? *Banks in Greece* and other heavily indebted countries have to fear nearly every attempt to solve the crisis. Only in the case of fresh money and euro bonds their future existence is not endangered. In all other cases they will survive only when state aid is guaranteed from the euro-zone. The same holds true with respect to *creditor banks*. For them however it is important to which extent they are engaged in the crisis states. As we have seen private banks have reduced their engagement and devalued their credits to Greece to the fallen market prices.³⁰ Nevertheless, the more stable countries in the euro-zone should be aware of the banks’ request for rescue measures.

As far as *Greece and other states in trouble* are concerned the option of fresh money is the most favourable perspective for them: Refinancing their debt would be secured, own banks would not come under pressure and the control over the stabilization program would be a political one, leaving some room of manoeuvre. The pressure from the markets is limited. It is important to note that perspectives for growth and competitiveness are critical if not negative in all options. Only in the case that governments are in a position to implement substantial reforms even against massive protest positive prospects are in sight. That governments follow a policy of strict fiscal consolidation is most probable when they are under pressure from the markets (and not of rather negotiable political conditions). That is the case when a debt restructuring happens.

Contagion of other euro members from the Greek drama is a core concern of policy makers in the euro-zone. From this perspective two alternatives – Greece leaves the euro-zone and a hard debt restructuring is executed – are the most dangerous cases of all. Economists perceive it to be helpful that markets define the rules of the game. For politicians that has negative implications of contagion. For them fresh money, euro bonds and soft restructuring are less risky to infect other countries. Nevertheless, one question is not answered: Will the rating agencies and financial markets perceive a soft restructuring as coming near to a default or not. If the answer is yes politicians will have problems to be in favour of this option.

The last question is: what is the least negative option for countries which have to pay the bill? As far as *financial costs* are concerned all alternatives must be evaluated negatively. States which have kept in line with the criteria of the EMU have to pay for those which ignored the rules. Costs are not only sensitive as far as money is concerned. The *political costs* should not be undermined. The Prime Minister of Slovakia refused to contribute to the financial assistance for Greece arguing that Slovakia has undertaken severe reforms what Greece did not. When elections took place in Finland in April 2011 the party “True Finns” was the main winner not only with a populist but anti-European program. And surveys show that a majority of Germans would prefer the Deutschmark instead of the euro. When one of the alternatives of fresh money, euro bonds or a soft restructuring were chosen creditor countries have to be aware that the control over measures for consolidation would be rather weak. A debt restructuring could be sensitive to own banks – depending however on the amount of credits in relation to the core capital of the banks.

Conclusion: contagion as the main concern of policy makers

When heads of state and government convened in Brussels on 21 July 2011 they had to make a choice which of the alternatives mentioned above should be used to prevent Greece from becoming bankrupt and to stabilise the euro-zone. As the German Minister of Finance Wolfgang Schäuble declared policy makers should make use of all instruments.³¹ Following this logic the European Council took the following decisions:

First, a new programme was supported for Greece. Fresh money amounting to €109 billion shall be provided by euro-partners and the IMF. Greece is disburdened from

taking out new loans until 2014. “This programme will be designed, notably through lower interest rates and extended maturities, to decisively improve the debt sustainability and refinancing profile of Greece.”³² The implementation of the programme shall be monitored strictly.

Second, future loans to Greece from the European Financial Stabilisation Facility (EFSF) shall be lengthened to a minimum of 15 years and up to 30 years with a grace period of 10 years. Lending rates will be close to those of the EFSF (currently approx. 3.5% without going below the EFSF funding cost).

Third, the financial sector has indicated its willingness to support Greece on a voluntary basis. The net contribution was estimated at €37 billion. However, this contribution should not be overestimated as market prices of the banks’ loans tended to 50% whereas the agreement secured 80% of the nominal value.³³

Fourth, to improve the effectiveness of the EFSF and of the forthcoming ESM (European Stabilisation Mechanism) it was agreed that these instruments shall be enforced to act on the basis of a precautionary programme, that financial institutions shall be recapitalised through loans of governments, and that the EFSF and the ESM shall intervene in the secondary markets to avoid contagion.

Fifth, transfers from the structural funds of the EU to the benefit of Greece shall be paid on the basis of lower co-financing rates. The rate has been at a minimum of 15% in the past and it is intended to be reduced to 5%.

It becomes evident that the heads of state and government have been in favour of different instruments: First of all they have offered *fresh money* to Greece. Secondly, the decision to extend ESFS loans up to 15 to 30 years and to reduce lending rates brings the EFSF near to *euro bonds*. Thirdly, when the private sector engages itself on a voluntary basis that resembles very much a *soft debt restructuring*. Fourthly, when EFSF and ESM are allowed to act on the basis of a precautionary programme and to intervene in secondary markets the corner stone is laid for a *European Monetary Fund*. Regarding figure 1 policy makers’ major motivation becomes obvious: They want to avoid contagion! That countries like Portugal, Spain, Ireland, Italy and Cyprus can be infected by the Greek malaise is the dominant concern. Additionally

policy makers want to control the critical situation by political means. They do not trust the markets to bring highly indebted states to correcting measures as it would be the case when a debt restructuring would be chosen. So, the weaknesses of the decisions of 21 July 2011 must be identified in the surveillance of reform steps and concrete measures of consolidation in states like Greece. No doubt, that tax payers in more stable euro countries and especially Germany will have to pay the bill. And when heads of state and government assisted the European Commission's proposal to reduce co-financing rates for transfers from the structural funds, new questions have to be answered: Is it possible to prevent windfall gains? This has been a major argument in the past why EU's structural policy was based on substantial national co-financing rates. Is it now seen as water under the bridge? And finally, shouldn't the principles of structural transfers be re-evaluated? In the past the major intention was to reduce regional disparities. Isn't it time to re-direct these transfers more to stimulate growth and competitiveness?³⁴ A chance is given as the new financial period 2014-2020 is under discussion actually.

References

¹ Cf. Eurostat

(<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=de&pcode=teina225&plugin=1>,
<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=de&pcode=tsieb080&plugin=1>,
accessed on 5.8.2011).

² For details, see the loan agreement, published by the newspaper BILD-Zeitung on 23.5.2010

(<http://www.bild.de/BILD/politik/wirtschaft/2010/05/24/griechenland-hilfe-deutschland-milliarden-euro/schwarz-auf-weiss-die-dokumente.html>, accessed on 10.2.2011).

³ Cf. Commission of the European Communities: Report from the Commission. Greece. Report prepared in accordance with Article 104(3) of the Treaty, SEC(2009) 197 final, Brussels, 18.2.2009, p. 4

(http://ec.europa.eu/economy_finance/sgp/pdf/30_edps/104-03/2009-02-18_el_104-3_en.pdf, accessed on 10.02.2011).

⁴ Cf. Frankfurter Allgemeine Zeitung, 12.3.2010, p. 15.

⁵ For a detailed discussion, see Heinz-Jürgen Axt: Griechenlands Schuldenkrise: Gefahr für den Euro? Das Dilemma von vertragskonformen oder politisch opportunen Lösungen, Duisburg 9.3.2010 (http://www.uni-due.de/imperia/md/content/politik/axt/gr_euro_axt_sog_20100307_1.pdf, accessed on 29.8.2010).

⁶ Cf. Heinz-Jürgen Axt, Griechenland: Bewegung in der Außenpolitik und Stillstand in der Sozial- und Wirtschaftspolitik (FES-Analyse), FES Library, Bonn, February 2002.

⁷ For evidence, see Heinz-Jürgen Axt: Griechenlands Schuldenkrise..., loc. cit.

⁸ Cf. Ansgar Belke/Hans-Peter Burghof: Jedes Land für sich selbst, in: Financial Times Deutschland, 27.9.2010 (<http://www.ftd.de/politik/konjunktur/eu-schuldenkrise-jedes-land-fuer-sich-selbst/50175118.html>, accessed on 11.2.2011).

⁹ The arrangements proposed by the Commission would imply that deficit procedures could be initiated more quickly and easily.

¹⁰ Cf. European Commission: Proposal for a Regulation of the European Parliament and of the Council on the effective enforcement of budgetary surveillance in the euro area, COM(2010) 524 final, Brussels, 29.9.2010 (http://ec.europa.eu/economy_finance/articles/eu_economic_situation/pdf/com2010_524de.pdf, accessed on 11.2.2011).

¹¹ Cf. Strengthening Economic Governance in the EU. Report of the Task Force to the European Council, Brussels, 21.10.2010 (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf, accessed on 11.2.2011).

¹² Cf. Conclusions of the European Council (28-29 October 2010)

(http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/de/ec/117499.pdf, accessed on 11.2.2011).

¹³ On 16-17 December 2010, the European Council agreed to add the following paragraph to Article 136 of the Treaty on the Functioning of the European Union: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality." (Conclusions of the European Council (16-17 December 2010)

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/de/ec/118604.pdf, accessed on 22.3.2010). The amendment takes place under the simplified revision procedure provided for in Article 48(6) of the Treaty on European Union (TEU), which allows the European Council, acting by unanimity after consulting the European Parliament, the Commission and, in certain cases, the European Central Bank, to adopt a decision amending all or part of the provisions of Part Three of the Treaty on the Functioning of the European Union (TFEU). Such a decision may not increase the competences conferred on the Union in the Treaties and its entry into force is conditional upon its subsequent approval by the Member States in accordance with their respective constitutional requirements.

¹⁴ Cf. Pascal Kauffmann/ Henrik Uterwede: Deutschland, Frankreich und die Eurokrise: Auf der Suche nach der verlorenen Konvergenz (<http://www.dfi.de/de/pdf/VerloreneKonvergenz.pdf>, accessed on 12.2.2011).

¹⁵ Cf. Sebastian Dullien: Ungleichgewichte im Euro-Raum, FES, WISO-Diskurs, Bonn 2010.

¹⁶ Cf. Pakt für Wettbewerbsfähigkeit (http://www.euractiv.de/fileadmin/images/Pakt_Wettbewerbsfaehigkeit.pdf, accessed on 12.2.2011).

¹⁷ Cf. Auf dem Weg zur europäischen Wirtschaftsregierung

(<http://www.bundesregierung.de/Content/DE/Artikel/2011/02/2011-02-04-eu-rat.html>, accessed on 12.2.2011).

¹⁸ Cf. Conclusions of the Heads of State or Government of the Euro Area of 11 March 2011

(http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119809.pdf, accessed on 22.3.2011).

¹⁹ Cf. Frankfurter Allgemeine Zeitung, 9.6.2011, p. 17.

²⁰ Cf. Frankfurter Allgemeine Zeitung, 7.6.2011, p. 19.

²¹ Cf. Hellenic Republic Ministry of Finance, Greek Parliament Adopts 2011 Budget, 23.12.2010

(http://www.minfin.gr/content-api/f/binaryChannel/minfin/datastore/40/fc/77/40fc77471e04b9efeeca007b9890dbc66939a80e/application/pdf/H EPP_NEWSLETTER_issue7.pdf, accessed 12.7.2011).

²² In Germany 190 professors of economic science supported a debt restructuring. See “Stellungnahme zur EU-Schuldenkrise“ (<http://www.wiso.uni-hamburg.de/lucke/?p=581>, accessed 12.7.2011).

²³ Cf. Roland Vaubel, Brady-Bonds – politisch attraktiv, ökonomisch falsch, in: Frankfurter Allgemeine Zeitung, 13.7.2011, p. 10.

²⁴ Risks for French banks are assumed to be higher than for German institutes. Cf. Frankfurter Allgemeine Zeitung, 16.6.2011, p. 13.

²⁵ One of them is the German Minister of Finance Wolfgang Schäuble who is confronted by opposition by most of his colleagues and the European Central Bank.

²⁶ The German Bundestag has declared on 10 June 2011 a substantive contribution of the private sector as a precondition for any new financial assistance for Greece.

²⁷ Cf. Frankfurter Allgemeine Zeitung, 12.7.2011, p. 23.

²⁸ In July 2011 members of the „Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung“ made the proposal that the EFSF could barter ailing Greek loans for loans of the EFSF. By that way the Facility would become a permanent guarantee and the proposal resemble the model of euro bonds. That became evident when one member of the “Sachverständigenrat” advocated a European treasury. Cf. Peter Bofinger interviewed by Tageszeitung, 18./19. 6.2011 (<http://www.economics.uni-wuerzburg.de/fileadmin/12010100/sonstiges/Bofinger-taz-18.6.11.pdf>, accessed 18.7.2011).

²⁹ See Ansgar Belke and Christian Dreger as quoted in Frankfurter Allgemeine Sonntagszeitung, 22.5.2011, p. 37.

³⁰ As the detailed analysis of the Frankfurter Allgemeine Zeitung (18.7.2011, p. 11) has made clear, the investment of German banks in Greece is limited. Risks with respect to Portugal, Spain and Italy are assessed to be more critical.

³¹ Schäuble will „gesamten Instrumentenkasten“ einsetzen (<http://www.faz.net/artikel/C30638/schuldenkrise-schaeuble-will-gesamten-instrumentenkasten-einsetzen-30461982.html>, accessed 8.8.2011).

³² Council of the European Union, Statement by the Heads of State and Government of the Euro Area and EU Institutions; Brussels, 21 July 2011

(http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf, accessed 8.8.2011).

³³ As the German economist Hans-Werner Sinn argued it is the tax payer who pays for the banks (Frankfurter Allgemeine Sonntagszeitung, 24.7.2011, p. 27).

³⁴ The author has pleaded for such a re-orientation. Cf. Heinz-Jürgen Axt, Alter Wein in neuen Schläuchen. Warum die Kommission nicht vom Ziel des Regionalausgleichs in der Strukturpolitik abgeht, in: Hartwig, Ines/Petzold, Wolfgang (ed.), Solidarität und Beitragsgerechtigkeit. Die Reform der EU-Strukturfonds und die Finanzielle Vorausschau, Schriftenreihe des Arbeitskreises Europäische Integration, Bd. 53, Baden-Baden 2005, pp. 11-37. When Chancellor Merkel and President Sarkozy met on 16 August 2011 they recommended that transfers from the structural funds should improve economic growth and competitiveness. Cf. Frankfurter Allgemeine Zeitung, 18.8.2011, p. 2.