The Greek Fiscal Crisis and the Future of the Euro-zone - a German View

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1. Understanding German Concerns

- Because Germany was hit twice in the last century by big inflations the aversion against inflation is especially high.
- The low German rates of inflation in the post WW II era were due to this aversion and the **German monetary constitution** (independent central bank, no monetary financing of public debts and legal obligation of the Deutsche Bundesbank to keep prices stable)
- The **European monetary constitution** of the **Maastricht Treaty** mirrors this **German monetary constitution**:
- because it was considered to be the best solution for the EMU (Delors Committee) and
- to gain the assent of German voters in favor of the EMU
1. Understanding German Concerns

- German voters had to be convinced to give up the Deutsche Mark (DM)
- which was the anchor currency of the EMS “German monetary hegemony” at that time and
- which was in the eyes of German the symbol of a successful economic recovery after WW II
- The fear of many Germans is that they will get a weak Euro in exchange for their stable DM because the rules of the Maastricht Treaty and the Stability and Growth Pact (SGP) will not be kept
- and in addition they will have to pay for those who get in trouble because they did not keep the rules
2. Nature of the Crisis

- The present Greek crisis is not only a fiscal crisis
- although the Greek public budget deficit and public debt are among the highest in the Euro Area (EA)
Public Deficits
ratio to GDP

Public Debt ratio to GDP

Federal Ministry of Finance; Monthly Report March 2010 (status quo: November 2009)
2. Nature of the Crisis

- and the financial markets demand ever higher interest rates (last week more than 5 percentage points higher than for German government bonds)
Interest-Spreads of Government Bonds Compared to German Government Bonds

2.1.08 21.5.08 8.10.08 25.2.09 15.7.09 2.12.09 21.4.10 8.9.10
2. Nature of the Crisis

- It is also very much a crisis of international competitiveness
- This is indicated by a high current account deficit of Greece which rose from 7% of GDP to 14% after joining EMU and is presently about 10%
Current account deficits in selected countries of the Euro Area in % of GDP
Unit Labour Costs in selected countries of the Euro Area

2000 = 100
3. Causes of the Crisis

- Foremost, **Greece did not take its EMU membership serious**
- It **forged budget figures** in order to be **admitted in 2001**
- As an **EMU member** it **continued** to do so year after year
- By this it **deceived** the **other EMU members** as well as **itself** and created **uncertainty on the true economic situation** of the country up to now
- It first **enjoyed the benefits of its EMU membership** by financing **government debt** at much **lower interest rates** than before
- The rapidly extended government debt was **used to preserve existing economic structures** which made the country **less competitive internationally**
- As it seems, **Greek politicians did not understand** that **EMU membership** means **significantly more systems competition** making **a policy adjustment necessary** in order to benefit in the medium to long run
3. Causes of the Crisis

- But **not Greece alone** caused the crisis
- The **European Commission** did not demand a **strict keeping** of the **convergence criteria** and the **rules of the SGP**
- This was already true for the **start of EMU in 1999**
- **In 2002**, one year after the admittance of Greece to the EMU in the second round, the then **president of the European Commission**, Romano Prodi, called the **SGP stupid**.
- After that, **could there still be expected a strict monitoring of the rules by the Commission?**
- When **Germany violated the deficit criterion** in **2003** the **early warning** of the European Commission was rejected by the **Schröder government**
- **Germany** and **France** did **not accept the deficit procedure of the SGP** but instead put through a **dilution of the rules**
- In the last **presidential election campaign in France** all candidates demanded changes of the European monetary constitution
3. Causes of the Crisis

- In sum, the **basic rules of the European monetary constitution** agreed upon in the Maastricht Treaty were **not respected**, neither by many member countries nor by the European Commission.

- After all, neither the **European Commission** nor **member states stopped the game**, but the **financial markets did**!

- The results of this **bad governance in the past** show up now and let **EMU enter a state of deep crisis**
4. Future of the Euro-zone

- At the moment, the **future of the Euro-zone** is very **uncertain**
- The present crisis demonstrates to the world that **Europe is unable to manage the EMU properly**
- The **IMF** had to be **called for help**
- **Financial assistance** of the EU to Greece means that the **rules of the Maastricht Treaty** and the **SGP** have to be **broken** (no bail out clause)
- By this, the **credibility** of the EU is seriously **damaged** and **moral hazard problems** are created
- Which **rules** will be **broken next**, which **country is the next** to ask for **financial assistance**?
- After all it is **very doubtful**, whether the **financial rescue program for Greece** will stabilize Greece and the **Euro-zone**
- First, it is **not sure** that the **Greek government can put through its ambitious consolidation program**
4. Future of the Euro-zone

- Second, what will happen to the mainly home driven Greek growth rate in the next years if the public budget deficit quota will be cut by more than 10% and the wages even more.
- Therefore, many observers expect that in a few months Greece will have to ask for even more help above the presently envisaged 45 bill. Euros.
- Greece needs a devaluation to become internationally competitive again.
- Within EMU only real depreciation is possible but hard to realize.
- In the end, it could turn out to be better for Greece or it could be forced by the financial markets to leave EMU and solve its debt problem by “haircuts” and give international banks a share in the costs.
- Since not only Greece but also other EMU members might demand financial assistance the EMU could turn into a transfer union.
4. Future of the Euro-zone

- It is **hard to imagine** that this could be a **sustainable solution**
- Other **proposals for stabilization**, e.g. **European Monetary Fund (EMF)**, **common Euro bonds**, **economic government** and **more coordination** in my view do not solve the **governance problems of EMU** convincingly
- They would **lower the pressure** that the rules of the **Maastricht Treaty** were intended to put on **all EMU member states** to care for policy **adjustment** and **higher international competitiveness**
- Only by this, a **higher welfare in Europe** will be brought about which **guarantees** the **assent** of people to **European integration**
- For the **future of the Euro-zone**, therefore, a **recollection of the original rules** of the Maastricht Treaty is of **utmost importance**
- As soon as possible a **credible agreement** and **self commitment** of all EMU members to **fully respect** and **keep** the **Maastricht Treaty** and the **SGP** is urgently needed
- **BACK TO THE RULES!**