Prof. Loukas Tsoukalis
Professor of European Organisation,
University of Athens
President of ELIAMEP

We can't go on like this:
Greek debt crisis and the euro

As the drama unfolds and the plot thickens, new actors join the stage and the tension rises. Purgation, or *catharsis*, releases emotions at the final stage of Greek tragedies. We may soon find out what form this will take in the real life drama the Greek economy is going through today, with or without the intervention of a *deus ex machina*.

Deficits, debt and credibility

It all began more than four months ago when the newly elected Socialist government in Greece announced a budget deficit of 12.7% for 2009, more than double its predecessor had claimed it to be. Greece is not the only country in Europe with a double-digit deficit. In fact, it finds itself in respectable company with countries such as the UK and Ireland, and the United States not far behind. But this deficit came on top of an already large accumulated debt exceeding one year's national output. Though other countries are catching up fast in the post-crisis world, Greece is ahead of the race.

Adding insult to injury, innocent (and less innocent) observers have suddenly discovered that Greek governments had been (shall we say?) economical with the truth and flexible about the way they handled statistics. They are also finding out that international banks had helped to camouflage public debt. When irresponsible politicians collide with greedy bankers, the seeds of an economic disaster are being sown. True again, this has not happened only in Greece: less innocent observers are fully aware. But large deficits and debt, combined with mismanagement and lack of credibility, have produced an explosive mix in the Greek case.

Large deficits and debt, combined with mismanagement and lack of credibility, have produced an explosive mix in the Greek case

When the news broke out, the new government in Greece was slow in its response, trying to reconcile electoral promises with hard reality as well as opposing tendencies within the party. Thus, European institutions and Greece's partners in the EU began to exert strong pressure on Athens, directly and through leaks to the press, to force it to take action. Rumours were mixed with hard facts and markets reacted the way financial markets often react.

Having underestimated risk for many years, markets are now getting scared of rapidly rising sovereign debt everywhere as governments are trying to sort out the mess created in the first place by an unregulated global financial system that had ran amok. Is it a paradox or hubris? Perhaps both – they are Greek, anyway. In the meantime, some people have been trying to make a quick buck in murky markets dealing with sovereign credit default swaps. Speculation can be highly destabilising in such markets, prophecies (and bets) become self-fulfilling, while there is apparently considerable room for manipulation.

Speculation can be highly destabilising in such markets, prophecies (and bets) become self-fulfilling, while there is apparently considerable room for manipulation

Not surprisingly, the crisis has quickly reached beyond Greece's frontiers: there are other vulnerable members of the eurozone and beyond. As a result, the euro has weakened against the dollar: a welcome development for European exporters in times of stagnant domestic demand, though not one to be officially acknowledged. In times of low growth and high unemployment, competitive devaluations between the major currencies (and other lesser mortals) are not rare; this one was clearly unintended.

Greek determination and European solidarity

Most Greeks have now realised that the problem goes deeper than a mere budgetary crisis would indicate

There is no denying that the prime responsibility for dealing with the Greek problem lies with the Greeks themselves. The government has submitted to the European Commission its stability and growth programme, and a succession of new measures has been added since then. The aim is to reduce budget deficit by ten percentage points of GDP in three years. Surely, it will be hard going: difficult years lie ahead for the Greeks. But there is enormous slack and wastage in the public sector, while the adoption of long delayed structural measures should help to alleviate the pain of adjustment.

The Greek economy has been long suffering from bureaucratic strangulation, which usually goes hand in hand with corruption, closed professions and protection of vested interests. Credibility will need to be regained the hard way, and European institutions will (and should) be watching closely. There will be strikes and resistance to liberalisation here and austerity measures there from those expected to lose. If anything, Greeks do not have a reputation for enjoying pain.

There is a thin dividing line between fiscal stabilisation on the one hand, and economic depression on the other brought about through a downward spiral of deficit reduction measures and negative rates of growth

The good news is that the government is now shifting fast from rhetoric to action, the main opposition party is backing austerity measures, while the large majority of Greeks, according to opinion polls, seem ready to go along. Arguably, the better news is that most Greeks have now realised that the problem goes deeper than a mere budgetary crisis would indicate. It has to do with clientelistic politics, a large, inefficient and increasingly corrupt state, as well as the prevalence of 'get rich fast and spend even faster' mentality in a society that has undergone rapid transformation and sometimes seems to have lost its bearings. Greeks may be at long last ready for big change: crisis is after all the mother of change. Of course, they will need a political leadership that enjoys credibility among citizens and has the capacity to unite and inspire. This will be the crucial test.

The large majority of Greeks appear ready to give the government the necessary breathing space to begin implementing its programme. It has proved more difficult to convince European institutions, while hedge fund managers and others have been betting heavily against Greek government bonds. The Council has endorsed Greece's stability and growth programme, albeit grudgingly knowing full well that the devil lies with implementation: the Greek record is certainly not good. And it has asked for more and specific measures.

Creating the conditions for higher growth in the future is one thing, ever more measures to reduce the deficit today and tomorrow are another, and they can go so far. There is a thin dividing line between fiscal stabilisation on the one hand, and economic depression on the other brought about through a downward spiral of deficit reduction measures and negative rates of growth. It would be dangerous to cross it.

We Europeans often indulge in stone throwing at each other as if we were not all living in a glasshouse

Doubts have been publicly expressed, sometimes accompanied by (unofficial) disparaging comments about the capacity of Greeks to be financially or otherwise responsible: 'it's all in the DNA, you know'! Despite our many years of shared sovereignty (some dare not admit it in public), we Europeans often indulge in stone throwing at each other as if we were not all living in a glasshouse. It gets nasty and dangerous on occasion.

Official doubts about the credibility of the Greek stabilisation programme have fed into market speculation – and these are markets that are neither efficient nor transparent. Some European politicians have recognised the problem, others still prefer to ignore it or even pretend to live in an imaginary world in which global financial markets resemble outdated textbook models of the academic world.

When you put together the low credibility of Greece and the state of denial and/or indecision in which several European politicians found themselves in these times of crisis, you end up with something dangerous for Greece and potentially also for the euro and the European system more generally. Responsible leadership has been so far in short supply.

These are times when *sauve qui peut* reactions risk undoing what has been painstakingly put together over many years. I mean Europe's regional construction resting on the three pillars of competition, cooperation and solidarity as Jacques Delors has so aptly described it. This is a construction we should be proud of and try to preserve, indeed strengthen.

Greek determination to stay the course and European solidarity, with conditionality and close monitoring, is precisely what is needed at this difficult juncture

As long as the medicine prescribed is the right one and in the right doses, thus not risking too much to kill the patient, European institutions and partner countries should help to ensure that the Greek stabilisation programme is given a chance to be implemented. In practice, this would mean trying to calm down the animal spirits of financial markets and, only as a last resort, provide a loan with conditions attached. There are several ways of doing that, if it were to become necessary.

The question is not whether Germans and others should be paying for the Greek debt. This is not the issue – and it should not be. Greek determination to stay the course and European solidarity, with conditionality and close monitoring, is precisely what is needed at this difficult juncture. Flagellation and prohibitively high interest rates would surely not solve the problem: they would make it worse and risk spreading it to others. The Greek debt crisis may be a precursor of things to come as sovereign debt climbs up everywhere, itself a by-product of the crisis.

Strengthening euro governance

Economic and monetary union was the offspring of the Franco-German couple... It is up to the same couple... to lead the transition from innocent childhood to adolescence and beyond

In its eleventh year, the European single currency – the most daring act of integration since the very beginning – is going through a difficult test of endurance. Some of us have always thought of European monetary union, combining a common monetary policy, a loose framework for the coordination of national economic policies (not only for Greece) and a highly decentralised political system, as a post-modern construction defying the laws of gravity. But that was all that was politically feasible at the time of creation. Now, it is high time for the euro to acquire solid foundations.

Economic and monetary union was the offspring of the Franco-German couple, President Mitterrand and Chancellor Kohl to be precise. It was about high politics and peace on the continent, much less so about economics. It is up to the same couple, now represented by President Sarkozy and Chancellor Merkel, to lead the transition from innocent childhood to adolescence and beyond.

The euro cannot simply operate on the principle 'it's good for you, if it hurts': it would be very bad economics

Those betting against the survival of the euro never understood or cared how much political capital has been invested in it

The eurozone needs stronger and common regulatory mechanisms for financial markets. Some progress has already been made in this direction, but it is still modest and arguably inadequate to prevent another crisis in the future. The eurozone needs single representation in international institutions, such as the IMF. The Europeans have been liberal with words but often unable to put their votes (and policies) where their mouth is. It also needs close and increasingly binding coordination of national economic policies, combining incentives and sanctions, coupled with effective surveillance and conditional assistance. The eurozone can benefit from the long experience and the accumulated expertise of the IMF in these areas. It should not, however, expect the IMF to do the job for it. The credibility of the euro is at stake.

It is a matter of urgency to strengthen the governance of the eurozone and create the necessary mechanisms to deal effectively with centrifugal tendencies and speculative attacks. We needed them yesterday, not in 2020. Admittedly, anything more than soft coordination of national economic policies is easier said than realised. There will be further constraints on economic sovereignty. But we should have known that when we set up the euro.

Surely, coordination of national economic policies should not be a one-way street. While Greeks, Spaniards and others tighten their belts trying to restore some of their lost competitiveness, the Germans need to boost domestic demand. The external deficits of Southern Europeans have their counterparts in the large surpluses of Germany and the Netherlands. Does it remind you a bit of the financial imbalance between the United States and China? The euro cannot simply operate on the principle 'it's good for you, if it hurts': it would be very bad economics.

A more effective governance of the euro may constitute a key element in a new grand European bargain, including a renewed commitment to the internal market, measures to ensure the transition to a low carbon economy, and new taxes on financial transactions as well as on polluting activities. In times of soaring budget deficits, governments are looking for new sources of revenue, while tax competition is being viewed increasingly as an unsocial, and indeed dangerous, sport. Governments that have defended for long tax competition as being compatible with the internal market are now beginning to change their mind. This may prepare the ground for a minimum of tax coordination at the European level. The Germans, among others, might be interested in such a grand bargain.

This is a very tall order indeed, and the political odds are against it. But the stakes are also very high. Those betting against the survival of the euro never understood or cared how much political capital has been invested in it. It is now up to all those involved in this joint enterprise to prove them wrong. We have done it before in difficult circumstances. The European Union and the euro are living proofs of it.