

*REBOOTING EUROPE*

# How to fix Europe's monetary union

Views of leading economists

Edited by Richard Baldwin  
and Francesco Giavazzi



**A VoxEU.org Book**

# Epilogue

Epilogue: Future history – how the crisis might have been handled

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# How the Euro Crisis was successfully resolved

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*When the newly elected Greek government of George Papandreou revealed that its predecessor had doctored the books, financial markets reacted violently. This column discusses the steps implemented by policymakers following this episode, which were essential in resolving the Crisis. What is remarkable, in hindsight, is the combination of pragmatism and reasoning based on sound economic principles displayed by European leaders. Instead of finger pointing, they acknowledged that they were collectively responsible for the Crisis.*

Now that the Crisis has long since passed, it is easy to forget how close the Eurozone came to a disaster. When the newly elected Greek government of George Papandreou revealed that its predecessor had doctored the books, financial markets reacted violently. While Greek, Portuguese, and Italian government bonds had been good investments so long as spreads on these assets continued to converge toward those on German bunds, Papandreou's revelation was a reminder that such convergence was no certainty.

## **Recognising Greece's unsustainable debt**

What happened next – a set of decisive steps that quickly resolved the Crisis – was nothing short of a miracle, made possible by a combination of steely resolve and economic common sense. In their historic 11 February 2010 statement, European heads of state and government acknowledged that the Greek government's debt was unsustainable. Rather than 'extend and pretend', they faced reality. Lending Greece even more money

would only render it even more heavily indebted and force it to undertake an even more draconian fiscal consolidation in order to maintain the fiction that it could pay back what it borrowed. In any case, there could be no bailout of the Greek government, given the Maastricht Treaty's prohibition of such measures. Greece, European leaders insisted, had to restructure its debt as a condition of external assistance.

To be sure, the market reaction was not favourable, and not all politicians agreed. Spreads on Greek public debt, which had been minimal as long as markets anticipated a bailout, widened further. Papandreou placed urgent calls to European heads of state and to Jean-Claude Trichet, President of the ECB. Restructuring the country's debt would take time, he reminded them, and for the moment Greece had a 15-percent-of-GDP deficit to finance. The only way of financing it, Papandreou argued, was for the country's Eurozone partners to extend a bridge loan and for the European Central Bank to provide Greek banks with Emergency Liquidity Assistance (ELA).

Papandreou, in fact, was not enamoured of having his name added to the long list of Greek premiers forced to oversee a default. Much of the Greek government's debt was held domestically, so restructuring it would not exactly burnish his popularity. Foreign banks also held Greek debt, and the impact of restructuring on their solvency was uncertain. A Greek restructuring would also raise questions about whether other highly-indebted European sovereigns would follow. Default, Papandreou cautioned, could be another Lehman Brothers, only worse.

European leaders displayed admirable calm in the face of these dire warnings. Trichet, rather than opposing debt restructuring, opposed the Emergency Liquidity Assistance, noting that the ECB's mandate limited it to lending against good collateral. German Chancellor Angela Merkel and French President Nicolas Sarkozy, not happy that their banks had recklessly taken positions in Greek bonds, agreed that those banks should now bear the consequences. If banks failed, then the German and French governments would resolve them, bailing in stakeholders while preserving small depositors.

Chancellor Merkel was adamant: asking Greek taxpayers to effectively bail out foreign banks was not only unjust but would aggravate moral hazard. The German public, still enraged by the bad bank behaviour that led to the financial meltdown, backed her hard line. Sarkozy may have been less firmly committed, but he was convinced by Merkel's argument that another bank bailout would ruin his chances of re-election.

### **Greece seeks the help of the IMF**

Seeking a more congenial alternative, Papandreou's next stop was the IMF. Its managing director, Dominique Strauss-Kahn, was happy to do business. The question was what kind of business exactly. The US Executive Director, always an influential voice in the Board, argued against a debt write-down. Channelling the views of the US Treasury, he warned that weak European banks could collapse, triggering contagion to already-weak US banks. Better would be for the IMF to ignore its 2002 Framework on Exceptional Access and extend Greece a large loan, as much as 30 times quota, on systemic-stability grounds.

However, IMF staff's debt-sustainability analysis showed that Greece's debt was already too high for this large loan to be paid back. Stabilising the debt/GDP ratio in its wake would require a massive fiscal contraction that would plunge the country into depression. Fiscal multipliers estimated in house predicted that GDP could fall by 25% in three years. This was no way for Strauss-Kahn to advance his French political ambitions. The managing director quickly concluded that the expedient path was to ally with European leaders and embrace the priority they attached to debt restructuring.

At the landmark meeting of the IMF Executive Board on Sunday 10 May, European directors overrode the objections of the US Executive Director. The Board agreed on a programme assuming a 50% haircut on Greek public debt. This would make it possible for the Fund to lend Greece just enough to finance a budget deficit of 10% of GDP for three years, supporting continued growth or at least limiting the depth of the country's recession. Fiscal consolidation was still required but for the moment would be limited

to 5% of GDP, which was just possible for Greece's new national union government to swallow.

In return for this help, Greece was asked to prepare a programme of structural reforms, starting with product market reform and proceeding after that to labour market reform. (Product market reform first because it lowered prices and increased households' spending power, thereby not worsening the recession, labour market reform second because it lowered wages and reduced households' spending power only later when the economy was better able to handle it.) Programme documents gave the Greek authorities considerable leeway in the design of these measures and acknowledged the reality that they would take time to implement.

The Greek government having been reassured of IMF support commenced negotiations with its creditors. A market-based debt exchange, in which investors were offered a menu of bonds with a present value of 50 cents on the euro, was completed by the end of the year.

## **Spain and Ireland in distress**

The French and German authorities nationalised their worst-hit banks and bailed in their large creditors. Spillovers to the US and global financial systems were minimal. Members of the Bundestag congratulated themselves for having defeated moral hazard. The French lionised Mr. Sarkozy, the presidential candidate now wearing the mantle of François Mitterand, the esteemed leader who nationalised banks in 1981.

But, as Papandreou had predicted, what happened in Greece didn't stay in Greece. If restructuring could happen there, then it could happen anywhere, the obvious candidates for 'anywhere' being Ireland and Spain. Both countries had experienced massive housing bubbles, which started deflating in 2007, bequeathing problems for their banks. Now the prices of bank CDS (insurance policies for the banks) plummeted,

and risk premia on Irish and Spanish bonds soared as investors bet on the probability of a government bailout of the banks.

On 18 October 2010 Merkel and Sarkozy took their famous walk on the beach in Deauville, after which they issued a joint statement affirming that unsecured creditors would be bailed in. Markets were alarmed, but Merkel and Sarkozy stayed the course; there was no waffling over the merits of bailout versus bail-in. At the stormy European Summit that followed, they insisted that Ireland and Spain administer the same medicine ingested by their own banks. The Irish and Spanish authorities dutifully obliged, bailing in unsecured creditors while protecting small depositors. Where the funds from unsecured creditors were not enough, they broke their insolvent lenders into good and bad banks, allowing the good banks to resume lending while the bad banks were wound down.

But if bank creditors could be administered a haircut in Ireland and Spain, they might also take a haircut elsewhere. Deposits haemorrhaged out of Italian banks, and the prices of bank bonds fell further. European leaders responded in December 2010 with what came to be known as ‘Banking Union’. All countries raised deposit insurance coverage to €100,000. A common fund to backstop national deposit insurance schemes was immediately created using dedicated fiscal transfers, with the proviso that these transfers would be returned to sender as levies on the banks flowed in, fully capitalising the fund. To reassure governments that calls on the common fund would be limited, the ECB was given supervisory authority over the member’s banking systems.

Still, confidence once damaged does not return overnight. The success of bail-in, banking union, and Greek structural reform were all uncertain. Investors continued to dump the bonds of weak Eurozone economies, straining government finances and causing questions to be asked about the very survival of the euro.

The answer came with Trichet’s famous ‘do whatever it takes’ speech in London in late 2010, the ECB president having concluded that the central bank’s lender-of-last-resort responsibilities trumped his desire to be seen as a Teutonic-style inflation fighter.

Recognising that bank resolution, however well organised, took time, the ECB cut interest rates repeatedly in early 2011 to offset the deflationary effects. It then initiated a programme of quantitative easing, purchasing government bonds at a rate of €100 billion a month initially for two years. That spreads had fallen made the nationality of those bonds a non-issue, which in turn made this substantial volume of purchases possible. Lower spreads also made it easier for the Irish and Spanish governments, both lightly indebted, to continue running modest budget deficits, thereby supporting the continued expansion of their economies.

It helped that Germany, with leadership from Merkel, relaxed its efforts to eliminate its own budget deficit. Ever the realist, Merkel concluded that it was impossible to keep turning down other countries' requests for a bailout without offering a helping hand in the form of faster growth in Germany. She accepted the argument, made by the IMF and the Commission that resolving the Crisis required rebalancing within Europe and that rebalancing could not occur solely through deflation in other countries. It required higher wages and prices in Germany.

Following the Nice Summit, the chancellor therefore asked her finance minister, Wolfgang Schaueble, either to resign or to abandon his contractionary fiscal policy. Schaueble, long a proponent of 'ever closer union', reluctantly accepted that fiscal expansion was a necessary price in order to achieve this precious goal. The Merkel government took advantage of the unprecedentedly low level of interest rates to propose a bond-financed programme of infrastructure spending, boosting its popularity at home and stimulating faster growth not just in Germany but in its Eurozone partner economies as well.

## **Concluding remarks**

Thus, by the end of 2012, following three years of turmoil, the Crisis was over. Growth in Europe had resumed. That growth enabled governments to begin narrowing their budget deficits, reassuring the markets of the sustainability of their debts. Aggressive



easing enabled the ECB to hit its 2% inflation target. With prices rising by 4% in Germany, rebalancing within the Eurozone proceeded without forcing a disastrous deflation on countries like Greece.

What is remarkable, in hindsight, is the combination of pragmatism and reasoning based on sound economic principles displayed by European leaders. Instead of finger pointing, they acknowledged that they were collectively responsible for the Crisis. Rather than allowing macroeconomic policies to be dictated by ideology and doctrine, they modified their policy stance in response to evidence. Instead of allowing their decisions to be dictated by the bank lobby, they stood by their no-bailout rule. The IMF similarly stood by its principles, pushing for debt restructuring and relief despite warnings of impending disaster by the bankers.

The Dutch and Finns, among others, continued to suggest that the Stability and Growth Pact should be strengthened through the application of even more intrusive and bureaucratic measures. Old ideas die hard. But as fiscal positions strengthened, their counterproductive proposals were shelved. As debts declined to sustainable levels, control over national fiscal policies was restored to national governments. Those who claimed that the euro could not work without political union were proven wrong. The ultimate measure of success is that policymakers in various parts of the world are now actively contemplating own monetary unions of their own, following the European example.

This eBook collects essays from a broad range of leading economists on a simple question: “What more needs to be done to fix the Eurozone?” Although the authors disagree on solutions, there is a broad consensus on the list of needed fixes. These include:

- Completing the Banking Union;
- Breaking the ‘doom loop’ between banks and their sovereigns;
- Ensuring EZ-wide risk sharing for Europe-wide shocks;
- Cleaning up the legacy debt problem;
- Coordinating EZ-level fiscal policy while tightening national-level discipline;
- Advancing structural reforms for a better functioning monetary union.

Each chapter presents solutions to one or more of these challenges. Taken together, they are the most complete catalogue of solutions to date – representing views that range from calls for sharp increases in European integration to those that favour national, market-based solutions.

The authors, drawn from a wide geographic range and all schools of thoughts, are: Thorsten Beck, Agnès Bénassy-Quéré, Peter Bofinger, Giancarlo Corsetti, Paul De Grauwe, Barry Eichengreen, Lars Feld, Daniel Gros, Refet Gürkaynak, Matthew Higgins, Yuemei Ji, Sebnem Kalemli-Ozcan, Stefano Micossi, Tommaso Monacelli, Elias Papaioannou, Paolo Pesenti, Jean Pisani-Ferry, Chris Pissarides, André Sapir, Isabel Schnabel, Christoph Schmidt, Guido Tabellini, Volker Wieland, and Charles Wyplosz.

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ISBN 978-1-907142-96-3



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