Greece: Strophe and Antistrophe

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The Greek tragedy contains more than its fair share of irony. Perhaps the biggest irony of all is that in the drafting of the Maastricht Treaty on Economic and Monetary Union in the late 1990s, it was Germany that insisted on the "no bailout" clause. A Greek default in 2010 would have avoided Greece's fiscal troubles cascading into an existential moment for the European Union (EU). This is something many, including myself, proposed. But Germany and France did not want that. They feared that the damage it would do to the German and French banks that had gorged themselves on high-yielding Greek debt would further endanger a fragile global financial system. More debt was heaped onto already impossible-to-repay levels of debt. Greece's economic sustainability was sacrificed on the altar of European financial stability.

Greece did deliver a haircut to its creditors, but it was not enough. This is because the economic austerity that came with the first Greek bailout pushed the economy into a free fall. The sum of gross domestic product (GDP) shortfalls over the past seven years, the difference between each year's real GDP level and the 2007 level, is a staggering 135%. (This measure, which I learnt from Charles Wyplosz, better captures the hole Greece fell into than annual GDP changes.) Greek debt was cut, but GDP fell even further. Greece is the poster child of the anti-austerity cause.

Benefits to a Default

Once a country is in a fiscal mess, there are economic benefits to a default. The object is not to punish creditors, but to allow a country to quickly return to the capital markets. The shame of default often leads to new political leadership, which gives credibility to new fiscal commitments. In the shadow of default, creditors and borrowers act more responsibly. Over the course of financial history, international money often returns surprisingly fast after a default. There are a multitude of potential complications. If you are small enough or uninteresting enough for international portfolios to suffer no loss by ignoring you, the return could be protracted. Debt crises also breed a debtor's defiance that can keep foreign creditors at bay.

In Europe there is an additional challenge. To create a single financial system, it was thought necessary for the European Central Bank (ECB) to treat member state debt as largely equivalent to each other. But this would not be possible if countries could default. Prior to a default, banks would pass on to the ECB all the bonds issued by the troubled sovereign that they held in return for the same liquidity as offered on other sovereign bonds. The default would then be on the ECB holdings of the debt, with no discipline on the creditors and debtors, and forcing other member states to replenish ECB's capital. To avoid this, officials presented default as tantamount to leaving the Eurozone when there is, in fact, no economic or legal requirement that this should be so.

The easy alternative would be for the ECB to operate a system of haircuts for the liquidity it offered against EU sovereign bonds based on their credit rating —which it sort of does. But in reality, this is circular, because the credit rating is based on the rating agency's view of the willingness of the ECB to provide liquidity. The trick would be to link the haircut to an independent measure of debt sustainability, but not so directly as to pose a risk to debt sustainability itself. The ECB could auction liquidity up to an amount equal to 60% of the potential, not actual, GDP of the country. In a recession, when actual GDP fell below potential, liquidity would not unhelpfully follow suit. The reverse would take place in a boom, helping to dampen it. Calculating potential GDP is fraught with difficulties and such a rule would have to be brought in gradually, but its calculation does not need to be finely calibrated for this to work. It would also introduce greater fiscal discipline than the current process.

Design Default at ECB

At the heart of the Greek crisis is a design fault at the ECB. Recent developments do nothing to correct that fault and everything to send the EU hurtling closer to oblivion, powered along by two politically convenient, racially motivated, economic falsehoods of Greek unreliability and German rule-following. In reality the Greeks have gone to extreme lengths to comply with impossible-to-follow rules. Amidst an unprecedented collapse of GDP, the fiscal deficit has been slashed from 15.6% of GDP to 2.5%, more than in any other EU country. Despite unprecedented unemployment, public sector employment has been cut by 25% or 2,50,000. The Greek retirement age has moved from one of the lowest in Europe to one of the highest, higher than in Germany and France.

It is Germany that has repeatedly failed to comply. It overruled the no-bailout clause to protect its banks. It repeatedly flouted the Stability and Growth Pact during its own recession of 2002–04. Small, powerless economies automatically face greater disciplines than larger, more powerful ones. The real point of international treaties is to constrain the large so as to create a more sustainable world order that all can benefit from. The history and purpose of the EU is to keep its largest economy tightly within the fold of mutuality. Those who felt German enlargement was a risk to that were considered stuck in the trenches of history, but they may have been more right than wrong.

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