

WILL GREECE GO BANKRUPT AND KILL THE EURO?

The benefits and Cost of Helping Greece

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Resumen: Este artículo compara los beneficios con los costes derivados del salvamento griego, llegando a la conclusión de que los beneficios superan claramente a los costes. También se analizan las causas del problema, el papel de las sociedades de rating y la euforia previa especulativa, efectuándose unas consideraciones sobre el futuro del euro y del orden financiero internacional.

Palabras clave: Bancarrota Griega, Euro, Estadísticas en Grecia, Credit ratings.

Clasificación JEL: F33, F34, F36, F55, G15, G24.

Abstract: This paper compares the benefits to Greece, the Euro zone and the rest of the world arising from policies that prevent a Greek default and exit from the Euro with the costs of preventive policies. It concludes that the

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benefits exceed the costs, though unpredictable politics and nationalist aspirations may prevent the adoption of the rational policies. The paper also considers the causes of Greece's problems: the failure of lenders to ask for a proper risk premium on the country's bonds; Greece's publication of false economic data; the failure of credit rating agencies to down-grade its bonds; the global financial euphoria and supply of liquidity that made lenders disregard traditional standards in all their dealings. The paper recommends policies to ensure the proper functioning of financial markets to prevent future crises.

Key words: Greece bankruptcy, Euro survival, Greek statistics, Credit ratings.

JEL Classification: F33, F34, F36, F55, G15, G24.

This paper discusses first the benefits that accrue to Greece, other Euro zone countries and the world from policies that avoid Greece's bankruptcy and exit from the Euro. The second part outlines the cost and nature of these policies and presents a benefit/cost analysis suggesting that it is rational to continue with these policies. Also discussed is the possibility that unpredictable political forces threaten the use of these rational policies. The final part considers the causes of the Greek crisis in order to find policies that would avoid future problems with Euro zone countries facing severe and persistent fiscal imbalances. A summary and conclusions closes the paper.

I BENEFITS OF GREEK RESCUE POLICIES

Policies successful in avoiding Greece's bankruptcy and exit from the Euro would bring a number of benefits.¹ The first arises from the avoidance of financial turmoil that accompanies expectations of bankruptcy and currency devaluation. This turmoil would cause bank deposits and other liquid assets to be shifted

¹ For a more general discussion of benefits derived from the adoption of the Euro by all of the member countries of the currency union see Huerta de Soto (2012).

abroad, leading to the breakdown of the entire banking system, recession and unemployment. According to data from the central Bank of Greece, deposits worth over 70 billion Euros, which is equal to about 35 percent of the country's GDP in 2012 have been withdrawn from the Greek banking system since 2009, with 25 billion Euros deposited abroad and the remainder hoarded in cash.²

The second set of benefits involves the avoidance of a recession and unemployment that would accompany the uncertainty around the determination of the exchange rate for the new drachma; the size of the haircuts creditors can expect on their Greek bond holdings; the risk of creditors using foreign courts to seize Greek assets abroad; the magnitude of inflation certain to arise and its effects on the levels and distribution of incomes, social programs and taxation.

Third, the avoidance of Greece's bankruptcy and exit from the Euro would allow the retention of the gains brought joining the currency area, such as lower transactions costs in foreign exchange markets and the resultant increased trade and capital flows and, most important preventing its politicians from buying votes through the provision of benefits to interest groups while ordering the Bank of Greece to finance the resultant deficits by printing money.³ These vote-buying practices had resulted in a long history of Greek political business cycles involving inflation, devaluations,⁴ booms and recessions accompanied by unemployment and low economic growth.⁵ They ended with the adoption of the

² This information has been provided to me in private correspondence by Antonios Koumpias, who is a student in the Department of Economics, Duke University.

³ These practices are explained in Public Choice Theory, the development of which owes much to Nobel laureate James Buchanan (1967) and Mancur Olson (1971).

⁴ Following a hyperinflation in the wake of the Second World War, the exchange rate of the drachma against the dollar was fixed at 30. In 1998, the rate was 304. These data were found at (<http://greekcurrency.awardspace.com/greek-currency/history.htm>) and (<http://www.tradingeconomics.com/greece/inflation-cpi>).

⁵ For an account of Greece's modern economic history see Andritsoyiannis (2012) and Bitros (2012).

Euro because Greek politicians were unable to get the European Central Bank to monetize its deficits.^{6 7}

While the benefits noted above are impossible to document empirically, the fourth benefit from avoiding Greece's bankruptcy and exit from the Euro is evident from Figure 1.⁸ In expectation of the adoption of the Euro in 2000, during the 1990s the premium over German bond rates for the sovereign bonds of Italy, Spain, Ireland and Portugal narrowed because of the widespread belief that the use of the Euro would prevent political business cycles and eliminate all exchange risks. The same reduction in the risk premium on Greek bonds developed after 1998 when it became increasingly expected that the country would join the Euro zone. However, as the graph shows, after the global crisis in 2008 the risk premiums on all sovereign bonds increased again to levels above those that had existed before 2000. The premium for Greece has become the largest by far.

1. Benefits to Euro zone and rest of the world countries

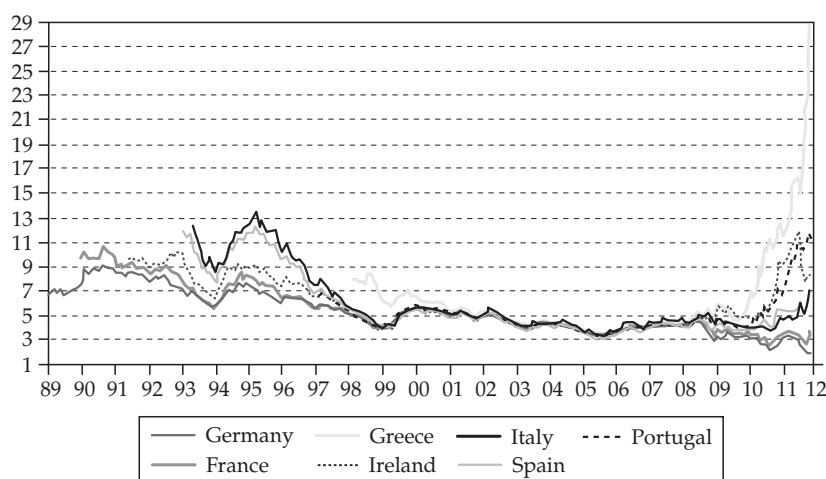
All member countries of the Euro zone would also benefit from the prevention of Greece's bankruptcy and exit from the Euro. The economies of Spain, Italy, Portugal, Ireland and some other countries with large fiscal imbalances would not be contaminated

⁶ For reasons to be discussed below, while the adoption of the Euro did eliminate the political business cycle, it did not eliminate the deficits resulting from the vote buying practices, as had been predicted by economic theory and noted in my study of the benefits and costs of creating a North American Monetary Union (Grubel 1999): «the union agreement..limits the ability of member countries to incur large and persistent budget deficits». (p. 15).

⁷ However, George Bitros pointed out in a private email that: «EU assistance played an important role since 1981 in glossing over the deficit spending behavior of all Greek governments. This "manna from heavens" helped all governments build a clientelist state on the perception that the EU largesse would continue ad infinitum. That is why I maintain that the EU leadership and authorities are partly responsible for what happened in Greece.» This conclusion is based on analysis contained in his forthcoming book *Creative Crisis in Democracy and Economy* in (2013), Axel Springer Verlag.

⁸ This figure is from Pomfret (2011).

FIGURE 1



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg.

by the spread of speculation in the wake of events in Greece and would avoid capital flight accompanying speculation about their fiscal conditions and possible exit from the Euro. At the same time, countries with strong fiscal positions, like Germany, would not have to deal with the problems speculative capital inflows would present them with. Avoided would also the risk that the collective resources assembled to aid Greece would almost certainly be insufficient to rescue these larger countries from speculative flight from their financial instruments.

If the Euro were replaced by a return to national currencies all of the short-run uncertainties mentioned above in the discussion of Greece's problems would arise. In the longer run, the micro-economic benefits from the currency union would be lost: savings from currency transactions and hedging; increased trade and capital flows and productivity and lower interest rates. Several of the Euro member countries would again suffer from their politicians' return to vote buying practices and the resultant business cycles.

The rest of the world outside of Europe would also benefit from Greece's fiscal recovery and retention of the Euro because

it would avoid the consequences of the financial turmoil and deep recession that would almost certainly develop in Europe.

It is not possible to estimate the dollar value of the benefits that Greece, Europe and the rest of the world are likely to enjoy if aid to Greece is sufficient to allow it to fix its fiscal problems and retain the Euro. However, it is clear that these benefits are very large in terms of lost output, unemployment, fiscal burdens and political instabilities.

II

THE COSTS OF GREEK RESCUE MEASURES

What are the costs of creating the benefits that arise from the prevention of Greece's bankruptcy and exit from the Euro through the provision of financial aid allowing the country the time to adopt austerity measures needed to restore fiscal balance?

These costs are related to the operation of two major collective European institutions. The first institution is the European Central Bank (ECB) in Frankfurt, headed by Mario Draghi. It has committed itself to accept toxic bonds of European sovereigns as collateral for loans to governments, calming markets and keeping interest rates low. The ECB has not purchased any Greek bonds but there are concerns that it is on a policy trajectory that will eventually lead to the purchase of sovereign toxic bonds and increases in the high-powered money base, much like that found in the United States due to the «quantitative easing» policies of the Federal Reserve.

All private and public holders of Greek debt will lose money if there is a large haircut in the value of the country's bankruptcy and its failure to service the debt. However, the total amounts are relatively small in a European or global perspective. The total of Greek government bonds outstanding amounts to about \$500 billion, compared to the debt of about \$530 billion of Lehman Brothers when it declared bankruptcy.

In the views of some observers, more important is the longer run problem that the new ECB policy violates its constitution, which requires it to pursue only price stability and disregard other

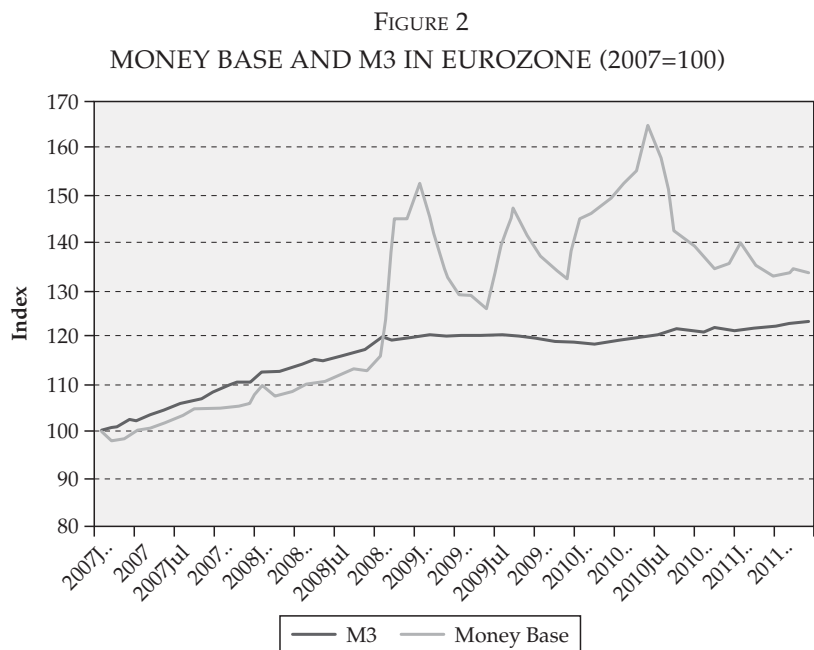
economic imbalances. This constitutional provision is valued highly by the people and governments of several European countries, especially Germany's.

More immediately, the policy carries the risk that the increase in the high-powered money base will result in inflation once bank lending revives and the money multiplier returns to normal. Like the Fed, the ECB promised to use all tools in its kit to reduce the money base and prevent inflation, but it remains to be seen whether this goal will be attained, especially in the light of all of the uncertainties around the nature and speed of economic recovery and the precedents that motives other than price stability often influence monetary policy.⁹

The magnitude of the injection of liquidity into all European banks, including those of Greece is shown in Figure 2. After the crisis developed in 2008 the index jumped from 115 to a maximum of 165 in July 2010 and has since decreased to 135. In the words of deGrauwe (2011) «In order to save the banking system, the ECB massively piled up assets on its balance sheets, the counterpart of which was a very large increase in the money base.» The graph shows that the European monetary policy has encountered the same problem as that in the United States. Banks have hoarded the liquidity injected by the central bank and the money supply in terms of M3 has remained stagnant.

The second collective institution involved in providing aid to Greece is the newly created European Stability Mechanism (ESM), the operational details of which had not yet been settled by the end of 2012. It will obtain its resources by contributions from private lenders but member countries as guarantors of the institution's debt are liable for its losses. The costs of the ESM depend, just like that of the ECB, on the future haircuts or default losses it will experience from its loans to Greece and other troubled governments. These costs are impossible to predict but they may be small since the goal of stable markets for sovereign bonds may be achieved through the possibility of ESM intervention, much like the existence of deposit insurance reduces runs on banks and the cost they otherwise would have caused.

⁹ For a discussion of these issues involving the Fed see Grubel (2011).



Source: ECB, Statistical Data Warehouse.

Whatever may turn out to be the losses of the ESM, the problem raised by some German legislators is that it will impose fiscal burdens on national treasuries without the explicit approval of parliaments, resulting in a loss of national sovereignty unwelcome by many Europeans. This concern remains in spite of the decision by the German Supreme Court that this practice is consistent with the German constitution.

The third institution providing aid to Greece is the International Monetary Fund, which is justified on the grounds that a Greek default and exit from the Euro would be costly also for the many countries that are members of the IMF. The IMF is always a preferred creditor and its claims are covered before those of any other creditors so that a Greek default would not impose costs on other member countries unless Greece was to leave the IMF, which is a highly unlikely scenario.¹⁰

¹⁰ This point has been made to me in private correspondence by Richard Cooper.

One final source of potential costs impossible to measure and the result of the policies of the ECB, ESM and IMF involves moral hazard behaviour, which increases the risk of governments running future deficits knowing that they can count on being bailed out. However, the seriousness of the moral hazard phenomenon is lowered by the fact that aid to needy countries is conditional upon the acceptance of conditions that are politically and economically onerous.

The actual effect of these conditions on behaviour is determined by the extent to which these conditions are enforced. One of the most effective enforcement mechanisms is the provision of aid in installments, the payment of which is dependent on progress in meeting the conditions. This policy is used by the providers of aid to Greece in principle but may turn out difficult to enforce as Greece's economy experiences an ever deepening recession and greater unemployment, the human problems of which have given rise to suggestions by the IMF to reduce the severity of conditions imposed on the further disbursement of financial aid.¹¹

It is important to note that the financial assistance provided by the ESM and IMF takes the form of repayable loans and its disbursement is conditional upon the adoption of specific austerity measures by the government. In the United States, such loans to financial institutions and companies like General Motors have been similarly conditional on measures taken to restore profitability and that they would eventually be repaid. Some of these US loans have been repaid and more repayment may take place in the future. It is possible that the same may happen with the aid given Greece, though only time will tell the final cost born by the providers of the aid.

Not yet in place is an agreement that would deal with the problems of national banks through collective agreements about a common deposit insurance scheme, regulations and supervision, as well as direct loans to troubled banks through a new institution.

¹¹ In October 2012, Christine Lagard, Executive Director of the IMF called for caution in the application of austerity measures in Greece to avoid casting the country into a catastrophic recession. See Jones (2012).

Negotiations over this system are not well publicized and appear to be progressing slowly. One reason is that it could result in costs imposed on national treasuries without explicit legislative consent, unless somehow it can be made to use private bank resources only and operate without public subsidies other than having the government backstop all claim on resources in extreme cases of need.

The acceptance of haircuts on Greek bonds held by private investors has imposed losses that are difficult to ascertain. Estimates run between 50 and 75 percent and may increase further. The agreements producing this result thus far are important because they were «voluntary» and avoided the need for the legal declaration of bankruptcy, which would have had many costly consequences for Greece and lenders without raising the prospect of a smaller haircut.¹² There remains the possibility that official holders of Greek bonds like the ECB will also have to accept write-downs. However, there is a somewhat ironic benefit from these haircuts suffered by the holders of Greek bonds. They will certainly in the future be more careful in lending to countries that are in fiscal difficulties, if only by insisting on large risk premia.

1. Benefits vs Costs

The full cost of the policies to help Greece just discussed cannot be measured. However, in making a benefit/cost analysis it is useful to understand that the economy of Greece is equal to only 2-4 percent of that of the entire Euro-zone. It is about equal to the size of the economy of Greater Miami in Florida; and that, as already mentioned above, Greek government bonds outstanding amount to about \$500 billion, compared to the debt of about \$530 billion of Lehman Brothers when it declared bankruptcy. Given these numbers it seems clear that the costs of aiding Greece are relatively small even if the collective institutions providing aid have to accept substantial haircuts on their holdings of Greek

¹² For the challenges facing creditors when sovereign nations face bankruptcy see William Rhodes (2011).

bonds and that the member countries of the Euro-zone have enough resources to cover them without affecting materially their own financial conditions.

The benefits from Greek assistance efforts are also impossible to measure but as they involve the avoidance of recessions, high unemployment and slow growth for very large populations and economies, it is safe to assert that they would be very big and far greater than the expected costs.

Based on these considerations, it seems clear that the benefits from aiding Greece are much greater than the costs, suggesting that it is rational to adopt all measures needed to bring the rescue efforts to a successful conclusion. The achievement of this goal implies that the danger of the break-up of the Euro-zone will be avoided and the Euro will survive.

This view has been expressed also by Otmar Issing (2012) who has had a distinguished career as a board member and chief economist of Germany's central bank and a member of the board of the ECB. He now is a professor at the Goethe University in Frankfurt, Germany. He expressed his optimism in a recent paper entitled «The Euro: It has happened, it is a challenging idea, it will last».

However, since economic policies are often based on criteria other than rationality, he hedges his prediction «it will last» by expressing it in terms of a probability and concluded only that the odds of a survival of the Euro are favorable.

The importance of the benefit/cost considerations also has persuaded Martin Feldstein (2012) to suggest now that the Euro existed, it was too expensive to let it fail. This judgement is particularly noteworthy since Feldstein consistently in the past has argued that the Euro should not be created since in his estimation, the loss of national economic sovereignty exceeded the benefits that had been identified by Robert Mundell (1961), who is often referred to as the «father of the Euro».

2. Risks on the Road

The probability that rational policies will prevail and the Euro will be saved is affected by a number of political and nationalist developments, some of which are decreasing and some are increasing the odds of the Euro's survival.

Negative influences exist in Greece, where populist parties opposing austerity measures have gained popularity and encouraged public demonstrations and riots, which in turn have slowed significantly the introduction of austerity measures by the government. At the same time, a deepening recession and high levels of unemployment are reducing tax revenues and increasing mandated social spending. It has also become clear that the Greek government's efforts to raise more tax revenue and to reduce entitlement spending are running into powerful opposition that is rooted deeply in a culture that is difficult to change quickly.

On the other hand, some developments bode well for the survival of the Euro. Legislatures in Greece, Spain and Italy have been adopting austerity measures and fundamental reforms that would have been impossible in the usual political environment.

Other positive developments have taken place in Germany and the Netherlands. As mentioned above, the German Supreme Court has found the use of the government's resources to aid Greece without specific approval by parliament to be consistent with the country's constitution. A political party in Netherlands that opposed the country's membership in the Euro-zone gained much popular support but was defeated in the last election.

Chances are that the restoration of fiscal balance in Greece and some other countries in Europe will take several years and progress unevenly. During these years new challenges to the rational policy of aiding Greece will arise and there is the risk that some will be successful. However, the case for financing Greece during its path to fiscal balance is so strong that much effort is warranted and should be made to see the project to its successful conclusion.

3. A Note on Benefits of Monetary Union

Readers should be aware of the fact that the preceding analysis of benefits accruing to Greece from the adoption of the Euro is inconsistent with the position taken by many economists who believe that Greece made a mistake adopting the Euro in the first place so that the exit would not cost anything and bring only benefits. This conclusion is based on the proposition that the micro-economic benefits are less than the macro-economic costs falling on Greece as its loss of monetary and exchange rate sovereignty prevented it from dealing optimally with random shocks affecting its economy. One of the most distinguished economists making this case is Martin Feldstein (2012), who provides references to others who agree with this conclusion.

Many other economists referenced by Grubel (1999) reach the opposite conclusion. Not only did Greece enjoy substantial micro-economic gains, its loss of monetary and exchange rate sovereignty was a blessing. It stopped the political business cycle and the adverse effects of random shocks were cushioned by access to the global capital market at low interest rates.

Moreover, the past records of all countries, but especially small countries like Greece, in the use of monetary and exchange rate policies to deal with economic shocks are poor and have often made problems worse.¹³ Shifting the responsibility for monetary policy to the ECB in Frankfurt with its greater intelligence resources and freedom from political influences in fact is likely to have increased rather than reduced economic stability in Greece from what it would have been outside the Euro. Based on this analysis, Greece did benefit from adopting the Euro and will retain them if it remains a member of the currency union.

Another objection to Greece's adoption of the Euro is based on the notion that its industrial structure, institutions and culture

¹³ See Friedman and Schwartz (1971) for evidence that faulty monetary policy caused and prolonged the Great Depression of the 1930s in the United States. Taylor (2009) argues that it was the excessive ease of US monetary policy, which caused the financial crisis of 2008 and its aftermath. Bitros (2012) documents the misuse of macro-economic policies in Greece's history.

are so different from those of other Euro countries so that it requires its own monetary and fiscal policy to deal with random shocks affecting its economy. By leaving monetary policy to the ECB, the cost of such random shocks is alleged to have been increased. Wolfgang Kasper and Manfred Streit (1999) suggest that Greece's culture of political corruption and cronyism are so different from that of other Euro-zone countries so that it cannot function properly within the zone's cultural standards.¹⁴

However, the validity of the standard argument about the need for similar economic and social characteristics as a condition for successful membership in a currency union is questionable since it disregards the effect the adoption of the common currency has on each country's economic structure, institutions and culture. For instance, if the austerity measures and other requirements for economic reforms imposed by Greece are successful, it will have become a suitable member of the Euro-zone by the standard static metrics. Frankel and Rose (1997) in an important article discuss more generally the role played by the adoption of a common currency on changes that in effect make these standard metrics endogenous to membership.

III PREVENTING FUTURE PROBLEMS

If in fact efforts to save the Euro are successful, there is the need to prevent future cases of countries running unsustainable deficits, threatening the existence of the Euro and endangering economic stability in the entire world. For this reason, it is essential to understand what caused the crisis in Greece.

At the beginning of this analysis it is important to deal with the often heard argument that Greece's problems are due to its membership in the European currency union and the use of the Euro. This argument is false and is equivalent to blaming the fiscal problems of the City of New York or the State of California on

¹⁴ In private correspondence Kasper used Greece's fiscal problems as evidence of the correctness of this proposition.

their membership in the dollar zone and use of the dollar to carry out commerce.

Instead, the fundamental cause of the fiscal crises in these jurisdictions has been the tendency of its politicians to spend consistently more money than they raised through taxes so that they ran fiscal deficits that had to be financed by selling bonds. This deficit spending had its roots in the politicians' practice of buying votes through the provision of benefits to interest groups while avoiding the loss of votes by passing on the cost to future generations unable to vote in current elections. This process is well known through public choice theory.

In Greece the practice before the adoption of the Euro had resulted in political business cycles as the politicians ordered the Central Bank of Greece to buy the bonds with newly printed money, which caused inflation, currency devaluations and unemployment. During the years 1960 – 2012, Greece's inflation rate averaged 9.4 percent. Between 1953 and 1998, the exchange rate of the drachma against the dollar fell from 30 to 305. While the inflation decreased the real burden of the public debt and in principle allowed the repetition of such cycles through time, it resulted in reduced economic growth, high average rates of unemployment and many statist policies needed to correct the social injustices and other problems caused by inflation and the devaluations of the currency.¹⁵

The adoption of the Euro was expected to end deficit spending and with it these cycles since the politicians could no longer order its central bank to buy its bonds. These expectations were expressed in my theoretical study of the benefits and costs of creating a North American Monetary Union (Grubel 1999) in which I noted that through membership in such a union «Canada is more likely to

¹⁵ This history is found in Bitros (2012) who cites studies by the Bank of Greece showing that the beneficial effects of devaluations were very transitory. See also Jovanovic (2012) for a record of recent Greek and European Union policies. In this context it is interesting to note that, according to Koumpias about one half of Greece's exports arise from its sale of shipping services, which are billed in dollars and use capital and foreign labour as their main inputs so that devaluations of the drachma do not have significant effects on the quantity and value of Greece's exports in dollars terms.

be protected from the adverse consequences of future misadventures in monetary policy» and that «the union agreement..limits the ability of member countries to incur large and persistent budget deficits: (p. 15).

However, while the loss of monetary and exchange rate sovereignty ended political business cycles in Greece, it did not end deficit spending. The low interest rates brought by the Euro may actually have encouraged it. This unexpected development is explained by the failure of financial markets to demand a higher risk premium on Greek bonds. As a result, the government avoided interest payments taking up an ever increasing share of its tax revenues, which would have forced it into bankruptcy unless it increased taxes or spent less. Most governments facing such alternatives have in the past avoided bankruptcy and its adverse economic and political consequences and instead accepted the much less costly tax increases and spending cuts.

One explanation of this puzzle is that the world's credit rating agencies failed to down-grade Greek debt as they were expected to do in the light of Greece's deficits and debt.¹⁶ As a result, lenders

¹⁶ The importance of credit ratings on the behaviour of governments is illustrated by the experience of Canada, with which this author is very familiar as a result of his personal involvement in the affair. Thus, during the early 1990s, large deficits prompted downgrades and higher interest rates for the government of Canada. This fact attracted much public attention and concern. In this atmosphere the newly formed Reform party made fiscal responsibility the center of its election platform and prompted me to run for office on its ticket. In the election the Reform Party gained enough seats to become the unofficial opposition in parliament, leaving with only two seats the Progressive Conservative Party, which had been in power while the large deficits developed and which, together with the other main party had denied that the fiscal imbalance was an important issue for the future of the country.

The government's austerity budget in 1995 is now often cited as an example of how spending cuts together with modest tax increases can restore fiscal balance and increase economic prosperity. The Finance Minister Paul Martin responsible for it told me, in my capacity as the Minister of Finance in the Reform Party's shadow cabinet that he had been able to get the austerity measures accepted by his party caucus only because of the widespread concern that without doing so, my party might win the next election. He asked me to keep up demands for greater spending cuts in my speeches in parliament so that he could adopt more cuts and look moderate in the eyes of his caucus. This experience indicates to me the role credit rating agencies can play in alerting voters to the importance of fiscal imbalances and influence corrective government policies.

using the information about Greece's credit worthiness in deciding to buy the country bonds continued to demand interest rates that were too low in light of the risks they carried. Why did this happen?

The answer to this question has two main components. First is the Greek government's practice of publishing misleading and occasionally falsified official statistics, which some have called «cheating» or «lying», though the resolution of the issues will not be helped through the use of such pejorative terms. Second is the then prevalent belief that European countries would never let one of its neighbours go bankrupt and provide all needed assistance to prevent such an event.

1. Misleading Greek Statistics¹⁷

The extent to which Greek deficit spending was hidden by government practices is discussed in Michael Lewis (2011), who is an investigative journalist and who had access to prominent individuals in Greece familiar with the facts and willing in personal interviews to share their experiences with him.

Lewis quotes George Papaconstantinou, an economist who had been working for the OECD in Paris before he took over as Greece's Minister of Finance in October 2009. The minister's words are in quotation marks:

The Greek government had estimated its 2009 budget deficit at 3.7 percent. Two weeks later that number was revised upward, to 12.5 percent, and actually turned out to be nearly 14 percent. [Papaconstantinou] was the man whose job it had been to figure out and explain to the world why.

«The second day on the job I had to call a meeting to look at the budget,» he says. «I gathered everyone from the general accounting office, and we started, like, this discovery process.» Each day they discovered some incredible omission. A pension

¹⁷ For a detailed, scholarly analysis of the problem with Greek statistics see Bitros (2012), this contains contributions by a number of Greek academics, statisticians and civil servants.

debt of billion dollars every year somehow remained off the government's books, where everyone pretended it did not exist, even though the government paid it; the hole in the pensions plan for the self-employed was not the 300 million Euros they had assumed but 1.1 billion Euros; and so on. «At the end of each day I would say, "Okay, guys, is this all?" And they would say, "Yeah." The next morning there would be this little hand rising in the back of the room: "Actually, Minister, there's this other one-hundred-to-two-hundred-million-euro gap." This went on for a week.» (pp. 7, 8)

Miranda Xafa, a Greek economist with a distinguished career in the Greek government, the IMF and private financial sector explained at a meeting in June 2012 that these problems were created by the lack of precision in existing international government accounting provisions rather than outright cheating. Thus, the rules allow governments to distinguish spending on current operations and on capital projects. By shifting some items of spending from the current to the capital budget, the reported deficit on current spending in Greece was reduced. Xafa mentioned as an example the subsidies that were paid to the publicly owned railroad, which were identified as investment when in fact they were used to cover running losses of the railroad and should have been reported as current expenditures.

The size of this misrepresentation is clear from the following quote from Lewis that includes in quotation marks Xafa's remarks:

...she pointed out in 1998 that if you added up all the Greek budget deficits over the previous fifteen years they amounted to only half the Greek debt. That is, the amount of money the Greek government had borrowed to fund its operations was twice its declared shortfalls. «At Salomon we used to call [the then head of the Greek National Statistical Service] "the Magician" because of his ability to magically make inflation, the deficit and the debt disappear.» (p. 12)

The Greek government also had private financial firms as allies in its efforts to understate its deficits. Lewis reports that Goldman Sachs helped Greece

to hide the government's true level of indebtedness...and taught the Greek government officials how to securitize future receipts from the national lottery, highway tolls, airport landing fees, and even funds granted to the country by the European Union. Any future stream of income that could be indentified was sold for cash up front and spent. (p. 12)

The preceding references indicate the extent to which the Greek government used what can be interpreted as manoeuvres that are allowed under existing rules, but it also engaged in some practices that are more difficult to justify. The following quotation describes what went on in preparation to Greece's adoption of the Euro in 2000 that was conditional upon acceptable levels of deficits and inflation:

To lower Greek inflation the government did things like freeze prices for electricity and water and other government-supplied goods, and cut taxes on gas, alcohol, and tobacco. Greek government statisticians did things like remove (high-priced) tomatoes from the consumer price index on the day inflation was measured. (p. 20)

The preceding information suggests that the manipulation of official government statistics was known by the credit rating agencies and private lenders. Why did this knowledge not result in higher interest rates on Greek bonds?¹⁸

2. Belief in a Safety Net

One reason is that lenders were convinced that the countries of Europe would not allow any of them go bankrupt by assisting them with whatever means were needed to escape a fiscal crisis.

¹⁸ A subsidiary question is why official publishers of national economic statistics, such as the IMF, OECD and Eurostat publish Greek statistics without challenging their validity or at least warn about their credibility. This issue is not pursued here but may be found in the same global financial euphoria used to explain the failure of credit rating agencies and lenders to act on the official statistics known to be misleading.

The efforts to help Greece after 2008 in fact justify this belief, but only to a limited extent. As mentioned above, the private holders of Greek bonds have lost as much as between 50 and 75 percent of their investment in the process of a «voluntary» agreement. The aid process has been halting, surrounded by uncertainty and may not be long and large enough to allow Greece to adopt its austerity measures successfully so that lenders may face even larger losses.

The belief in the ability and willingness of countries to prevent bankruptcies of others had deep roots in the financial euphoria, which had developed at the beginning of the millennium and lasted until the crisis in 2008, with a short interruption during the bursting of the high tech bubble in 2001. This euphoria was based partly on innovations in private capital markets in the form of derivatives and other complex financial instruments that resulted in a financial, economic and real estate boom. This condition was supported especially by the development of credit default swaps, which appeared to virtually eliminate all losses that until then had been the consequences of holding claims on bankrupt companies and by implication governments.

All of this risky lending was enabled by the excessively easy monetary policy of the US Federal Reserve (Taylor (2009)) and the demand for financial investments by sovereign wealth funds, which bought hundreds of billions of dollars worth of private and public sector debt (Grubel (2010)).¹⁹ Adding to the global financial euphoria was a US housing boom that was caused by US government policies aimed at encouraging private home-ownership and which induced home owners to use their nominal capital gains on their homes to take out loans for higher consumption spending, further feeding the boom and increases in house prices.²⁰ Financial institutions in the private sector facilitated this boom

¹⁹ For a different view on the causes of the 2008 crisis see Cooper (2011).

²⁰ See Lewis (2010) for a vivid description of the euphoria that had gripped the world's financial and housing markets and how it overwhelmed the warnings about its unsustainability made by some private analysts and investors, some of which became very wealthy from the investment decisions they had made in anticipation of the 2008 crisis.

by the development of mortgage backed securities used to channel funds into the mortgage market and private borrowers.

In this global financial environment, credit rating agencies saw no need to down-grade Greek bonds and investors continued to buy Greek debt obligations at low rates, which at any rate were a small proportion of their total investments and dwarfed by their holdings of mortgage backed and other new types of securities.

The financial euphoria ended with the start of the Great Recession in 2008. In the following years, governments and collective institutions have taken measures to return private markets to normal conditions and prevent future financial crises. Among other policies they have regulated markets for derivatives and swaps, increased the surveillance of financial intermediaries, applied due diligence to verify the accuracy of official statistics and imposed higher capital requirements on banks. In particular, the Greek legislature granted its statistical authority independence from political influence and Eurostat, the statistical branch of the European Union increase its surveillance of the Greek authority and other national statistical offices.

Capital market practices also have changed on their own initiatives. Credit rating agencies have resumed their normal roles, issuing down-grades on governments with excessively large deficits and debts. Lenders have bought sovereign debt only if interest rates are high enough to compensate them for the risk of default.

These private market practices are effective in preventing governments from engaging in fiscally irresponsible and unsustainable practices for reasons discussed above. They are also likely to be more reliable and effective than the new government policies. As the history of government efforts to regulate financial markets shows, they cannot prevent new crises in the longer run. The ability of private markets always finds ways to avoid existing regulations with new policies that carry the seeds of a new crisis. Regulatory authorities are unable to avoid such private market innovations as they are constrained by politics and bureaucratic inertia.

Of equal importance is the fact that the very existence of government policies to protect the public carries the risk that market participants reduce their efforts to gain information protecting them from losses and induces them to make ill-informed

investments. On the other hand, private lenders with the help of credit rating agencies and in pursuit of self-interest are much more likely to spot and act on the development of conditions that endanger not only their own wealth, which is closely linked to the entire financial system, the stability and health of which therefore is also in their interest.²¹

3. Policies to Prevent Future Crises

The implication of the preceding analysis is that to prevent governments from running excessively large deficits and accumulating unsustainable levels of debt, public policy should focus on the encouragement and maintenance of private market institutions and practices that send appropriate messages about the fiscal condition of individual countries through credit rating and the charging of risk premia. This policy has been recommended by Issing (2012) and is fully endorsed here because it prevents crises without depending on the use of unreliable political and bureaucratic actions.

If these private institutions function properly, they make unnecessary the creation of new public institutions that have been proposed for the purpose of preventing governments from running excessive fiscal imbalances in the future. One of these involves the creation of a European fiscal union with the authority to examine and approve national government budgets. This proposal has been resisted by most Euro-zone countries as an unwarranted intrusion into their national sovereignty. Moreover, they lack effective procedures to force countries to comply with the required budgetary changes.

Another proposal has been to require member countries to adopt legislated or constitutional prohibitions against deficit spending. While this method involves no loss of national sovereignty, in practice it has the disadvantage of requiring pro-cyclical changes

²¹ See Cooper (2011) for elaboration on the differing view that financial systems are inherently unstable and that the collective actions of private agents can result in global instabilities, so that only government regulation can prevent them.

in spending and taxation when a country experiences a recession. An additional problem has arisen in US states that have balanced budget legislation. Politicians have met the requirements by the use of accounting practices that shift incomes and expenditures between periods and into special accounts, much as had been done by Greece leading up to the crisis and discussed above.

The outstanding success is found in Switzerland, which recently dealt with the pro-cyclical effects of enforcing balanced budget requirements by new mandated rules that require the accumulation of funds during booms and allow their use during recessions.²²

IV SUMMARY AND CONCLUSIONS

After the start of the global economic and financial crises in 2008, the severe fiscal imbalances and high debt loads of the government of Greece have become a threat to the country's solvency and the stability and possible survival of the European Monetary Union. A Greek bankruptcy, its exit from the Euro and the accompanying spread of financial turmoil in Europe and the rest of the world would impose very heavy costs on the world economy. The costs of avoiding these calamities through the provision of aid to Greece during its move to fiscal balance are much less than the benefits gained by avoiding the country's bankruptcy and the exit from the Euro.

Therefore, it is rational for European and global collective institutions to provide Greece with all the aid needed during the time needed to restore its fiscal balance, making disbursement of funds conditional upon the successful implementation of austerity policies. If the world accepts this proposition, the odds are good that Greece will avoid bankruptcy and the Euro will survive, but these results are not certain because policies based on political and nationalist motives often trump rationality.

²² For discussions of the Swiss debt brake legislation see Bruchez (2003) and Geier (2011).

Understanding the causes of Greece's fiscal problems is essential for the design of policies that will avoid other members of the Euro-zone from experiencing the same problems in the future. One cause has been the hiding of true economic conditions in Greece through the manipulation of official statistics, which contributed to the failure of credit rating agencies to down-grade its ratings and the willingness of private buyers of Greek bonds to accept low interest rates.

These failures of rating agencies and lenders are attributable also to the general euphoria about financial and economic conditions and a very strong global economic boom that existed for several years before 2008. These conditions were caused by excessively easy monetary policy by the US Federal Reserve, the demand for financial instruments by sovereign wealth funds, US housing policies, the development of new financial instruments like derivatives, the securitization of mortgages and credit default swaps, and the general global economic boom due to the rapid growth of the Chinese and Indian economies.

While a wide range of government regulations of financial institutions have been enacted, policies to prevent European countries from fiscal irresponsibility are only in the discussion stage. Proposals for the establishment of public institutions charged with the collective approval of national budgets are bound to fail because they represent an unwarranted intrusion on national sovereignty. The optimal policy is to encourage and safeguard the traditional operation of credit rating agencies and lending practices of private investors.

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