EUROPE AFTER THE GREEK ELECTION

"Difficult Decisions for a Divided Europe"

AEI, Washington DC, 19 June 2012

My intervention will focus essentially on three points. The first is a broader one, going beyond this week-end's elections in Athens; the other two are more directly linked to the seminar's theme, i.e. the "difficult decisions for a divided Europe" that arise after the Greek election.

First, the broader point, which stems from the handling of the crisis to date, which sets the stage for what may ensue. As the saying goes, the past is prologue (aptly, from Shakespeare's "The Tempest"). And in that regard a lasting legacy of the Greek and euro area crisis are the changes it has wrought on some of the basic tenets that long governed the view of European integration on the one hand, and of crisis management and resolution on the other. These are basically three:

- The first tenet is that **the process of European integration is irreversible**. Now, not only is it evident that it *is* reversible, in some cases it is indeed in reverse (e.g., with respect to Schengen, and the fragmentation of banking), and the fears go even further, in the direction of complete disintegration. The latter remains unlikely, but the foundations of monetary union do remain shaky. While the smooth functioning of monetary union clearly requires further integration ("more Europe"), and the crisis has pushed EU leaders in this direction, the same crisis has also turned public opinion against this very process – be it due to adjustment fatigue in the periphery or to bail-out fatigue in the core. The strains in this process have altered the political equation of the euro project, and diluted the political glue that has kept the euro edifice together. Furthermore, there is a new awareness – now embedded in the market – that EMU is not an irrevocable currency union but a very rigid fixed currency system. Markets are now painfully aware that the euro is a composite, and thus "breakable" currency – and such awareness will continue to draw attention to its weakest link at any point in time, raising questions as to whether the country concerned will be able to continue to be a member. This is not a situation that can be sustained for long. The question is what gives: will it be opposition to fiscal union or the survival of EMU itself, at least as we know it? I believe the latter will win out in the end but, in any event, we are far from "irreversible" integration and "irrevocable" unions.

- The second tenet that has unraveled is the theory of **expansionary fiscal contractions**, with non-Keynesian effects – which long underpinned front-loaded approaches to adjustment. There are undoubtedly circumstances where this can be true, i.e., where a decisive policy to reduce both the fiscal deficit and high levels of debt can shore up market confidence and create expectations among the public about future income, thus favoring growth. A medium-term bipartisan plan addressing the U.S. deficit and debt could be a case in point. But there is no way this can hold for front-loaded adjustment when a recession is already under way and credibility is weak – which is the current situation in Europe. What you then have is, rather, the vicious circle between adjustment, growth, and the need for further adjustment, with the implosion of economies that we have witnessed. What this means is that there is such a thing as a "speed limit" to adjustment. In fact, the IMF itself (beginning with a study in the 2010 WEO, colorfully entitled "Will it hurt?") has concluded as much in theory, though unable to push it within the troika. The troika has continued to disregard this point, but it will need to face it in dealing with the New Democracy-led coalition that is to be the next government in Greece.

- The third tenet that has been swept away is that **providing public support to a crisis country can act as a catalyst**, generating confidence and triggering private capital inflows – we have all heard of the "catalytic role" of the IMF. Truth be told, research had already suggested that such catalytic effects are at best small for private flows once a capital account crisis has erupted. They do seem however to play in a different sense, i.e., official support can help prevent a crisis from erupting in the first place, and thus be "catalytic" with respect to the counterfactual in which private lenders would have exited. Such a case was that of Brazil in 2002, when the IMF committed unprecedented amounts of financing at a time of great market uncertainty prior to the elections. As the October 2002 elections drew closer, the fear of unorthodox economic policies under a Lula government induced both foreign investors and wealthy Brazilians to withdraw their assets from Brazil. To stem these developments, a decision was taken to provide a signal of continuity via a program supported by a bumper credit to Brazil, of $30 billion – far larger than expected to impress investors (an approach, incidentally, suggested by Tim Geithner, who was then on the IMF staff). This was a difficult decision at the time, and many

> saw it as the Fund taking undue risks. As it turned out, the risks did not materialize, and the experience illustrates the benefits of early intervention, via the mobilization (but not the utilization; as Brazil never drew) of considerable firepower. But Europe's management of the crisis has been inept to the point that official intervention is now not only always too late (certainly never pre-emptive), but it actually increases private sector fears, including those concerning subordination, and a rush for the exits. As put by Mohamed El-Erian: "The greater the erosion of policymaking credibility, the harder it is to get the private sector to buy into your plans. As a result, rather than crowd in private capital, seemingly bold policy measures end up facilitating its exit." Developments in Spain after the announcement of the bank bail-out are telling in this respect.

So, we find ourselves in a situation where the basic tenets that have guided European integration and international crisis management more generally no longer seem to hold. All of which make the "decisions facing a divided Europe" even more "difficult." For my remaining two points, I'll look at two of these decisions: what to do about Greece specifically, and what to do about monetary union more generally.

What to do about Greece specifically?

The only thing the elections seem to have done is to avoid an unraveling of the situation before or during our seminar, but we are still in the midst of this Greek tragedy. Even so, the drama will likely involve prolonged brinkmanship, in a huge chess game, in which no one will want to take responsibility for a Greek exit and the related fall-out.

In the mean time, official creditors will have little choice but to renegotiate the bail-out. Not only with respect to the interest rate and maturity of the loan, but also the pace of adjustment. Greece cannot of course avoid austerity: even if it walks away and repudiates all debt, it will still be unable to cover its domestic commitments, given the persistence of a primary deficit. In a nutshell, Greece can *vote* against austerity but it cannot avoid it. The issue is: does the dose of austerity really have to amount to 5½ % of GDP to be specified by June of this year and implemented in two installments, the first in 2013, the second in 2014, as envisaged under the bail-out agreement? Not only is this unlikely, but is it necessary? Is the "troika" replicating the Fund's errors in Asia in the 90s? Besides the timetable, the focus will need to be shifted from "mostly fiscal" to "more structural."

As this process unfolds, the key question will be: can the euro zone effectively ring-fence Greece and arrest contagion to other peripherals? Officials argue that the euro area is now better placed than it was some time back, with notably larger firewalls having been agreed. But the reality is less promising, and let me pass on to that, looking at:

What to do about monetary union more generally?

Here let me touch briefly on a few points that have not enjoyed much attention and that will likely come back to haunt the EU in the further unfolding of the crisis. These have to do with the workings of the ESM.

Many observers look to the ESM as an important part of the solution, calling in particular for it to be allowed to recapitalize banks directly – suggested officially by both Draghi and the Commission recently – so as to break the link between banks and sovereigns. In these appeals, the ESM is presented as standing ready to be tapped to its full potential.

Apart from the fact that the ESM is not yet operational (and one can doubt it will be by July 2012, given the obstacles to Treaty ratification in various countries), the more serious problem is that, even once it becomes operational, the ESM's lending capacity will be appreciably below the touted €500 billion (see table).

ESM Capital Structure and Lending Capacity
(in billions of euros)

Period	Paid-in Capital	ESM Lending Cap	EFSF Top-Up	TOTAL
Jul 2012-Oct 2012	16	107	248	355
Nov 2012-Jun 2013	32	213	248	461
Jul 2013-Oct 2013	48	320	n.a.	320
Nov 2013-early 2014	64	427	n.a.	427
Early 2014 onwards	80	500	n.a.	500

This is because the Treaty sets a minimum ratio of 15% between the ESM's paid-in capital and its outstanding loans. Thus, given the phased injection of capital (five equal installments spread over July 2012 and early 2014 – first column), the ESM's lending capacity is effectively constrained to no more than €107 billion at the opening of its doors (second column). True, it has been agreed that this amount can be complemented (until July 2013) by tapping the unused funds of the current EFSF (third column, currently equal to €248 billion). In sum, the total available at the ESM's start amounts to just €355 billion, which would actually decline to €320 billion in July 2013, when the EFSF will cease to exist and, with it, its unused funds (final column). In essence, the full potential of €500 billion will be reached only two years from now, in early 2014, unless the schedule for paid-in capital is accelerated.

Furthermore, whatever ammunition is made available, the necessary arsenal is not at the ready. Indeed, other than traditional stability lending, the other instruments foreseen – that is, precautionary loans, the financing of bank recapitalizations, and interventions on primary and secondary markets for government debt – are not part of the ESM's readily deployable toolkit. Though foreseen in the ESM Treaty, legal ambiguities arising from different decisions taken at different times[1] -- in a typical manifestation of time inconsistency – complicate recourse to these instruments, subjecting them to possibly lengthy negotiations on MoUs (required in all instances) amid the risk of complex legal disputes from some capitals (or seats of Constitutional Courts).

From all of this one can only conclude that official sources of financing remain uncertain, procedurally slow, and possibly inadequate. In seeking ways out of the crisis, it is thus best not to over-rely on them, and realize that – as things stand – the solution has to be found in other proposals on the table, such as eurobonds (or, as a start, the short-term eurobills that are now being proposed), a euro-wide deposit guarantee scheme, and centralized banking supervision, or banking union.

These are the key issues, since ultimately the crisis is not Greek as such, it is European and it has to do with European frameworks and governance. But their resolution takes time, during which the "bank jog" could well become a bank run. And, as noted, the need for "more Europe" clashes with electorates' current proclivities; the EU's unpopularity – once limited to a few traditionally euro-skeptic countries – is now continent-wide. Still, with Europe unwilling to plan for either a "core" union or a return to national currencies, there is little alternative to persevering on the road of integration as resolutely as possible, while doing a much better job at political pedagogy. Thus, the more far-reaching the decisions taken at upcoming European Council meetings, the better. What is needed is what ECB President Mario Draghi has called a "brave leap of political imagination."

[1] Notably the first basic legal text for the ESM adopted in March 2011, the subsequent decision to broaden the mechanism's interventions in July 2011, and the final ESM Treaty in February 2012.