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A Greek endgame?

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The crisis that started in Greece has given birth to a new crisis of the eurozone as a whole. There is no doubt that the major responsibility rests with the Greek authorities who mismanaged their economy and then deceived everyone about the true nature of their budgetary problems. The financial markets and the eurozone authorities, however, also bear part of the responsibility for letting the crisis degenerate into a systemic crisis of the eurozone.

The financial markets showed how unreliable their judgments can be in moving from excessive optimism before the crisis to deepest pessimism after the crisis broke. The use of CDS (credit defaults swaps) allows market participants driven by pessimism to speculate in unlimited amounts against particular countries, thereby greatly amplifying underlying problems.

The crisis was allowed to unfold also because of missteps on the part of both the eurozone governments and the ECB. The eurozone governments failed to give a clear signal of their readiness to support Greece. The ECB, in turn, created ambiguities about the eligibility of Greek government debt as collateral in liquidity provision.

The Greek government debt crisis *should* and *can* be stopped. It should be stopped because failure to do so could set in motion an unstoppable process of contagion that would affect the entire banking sector of the EU. This would in the end force governments to bail out banks once again at great economic costs. Thus the choice today is between two evils. The first one arises from moral hazard. Bailing out Greece is bad because it gives a signal that irresponsible behaviour will not be punished. The second evil arises from the contagious effects of letting Greece default. Authorities have to choose for the lesser evil, which in this case is the second one. This is also the choice that was made when they bailed out the banks that had been at least as irresponsible as the Greek government.

The Greek government debt crisis *can* be stopped. There can be little doubt that the eurozone member countries have the financial capacity to bail out Greece if the need arises. It would not cost them that much: if Greece were to default on the full amount of its outstanding debt, a bail-out by the other eurozone governments would add about 3% to these governments' debt levels. This would be a very small number compared to the sums spent to save the banks during the financial crisis.

The crisis has exposed a structural problem of the eurozone, created by the fact that the monetary union is not embedded in a political union. This imbalance leads to a dynamics of creeping divergencies between member states and there is no mechanism to correct or alleviate it. These divergencies in turn are at the core of budgetary divergencies and crises.

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Ideally the eurozone member countries should move forward into a closer political union, but there is very little prospect of this happening in a significant way in the foreseeable future. Some small steps are possible however. One is the creation of a European Monetary Fund; the other is the creation of common Euro bonds designed in such a way to minimise the moral hazard problem (see elaboration of these ideas in the papers referenced below). These steps have the important quality of signalling a determination on the part of the eurozone members to commit themselves to a future intensification of the process of political union.

Of related interest: P. De Grauwe and W. Moesen, “Gains for All: A Proposal for a Common Euro Bond”, *Intereconomics*, May/June 2009 and D. Gros and T. Mayer, *Towards a Euro(pean) Monetary Fund*, CEPS Policy Brief, No. 202, February 2010.