

Merkel's Folly

Erik Jones

Angela Merkel made a mistake. When confronted in late 2009 with the fact that Greece had been falsifying its fiscal accounts and faced a much larger fiscal deficit than originally expected, the German chancellor insisted that Berlin would not be providing any direct assistance.¹ 'Greece must accept its responsibility for reform', she said in an 11 December 2009 press conference following the European Council summit.² As the markets turned against Greece in the weeks that followed, she reiterated this line. When the European Union's heads of state and government met in early 2010 to resolve the situation, she refused to relent. Speaking with French President Nicolas Sarkozy at her side on 11 February, she repeated that Greece would have to focus on meeting its fiscal consolidation targets because 'the rules have to be followed'.³

Only in March did Merkel begin to admit that Greece might not be able to solve its problems in the bond markets by itself. Still, she insisted during her 26 March press conference after the European Council summit that Germany would only extend bilateral aid to Greece as a 'last resort ... when market financing is no longer possible'.⁴ She maintained that position for more than a month, adding in a press conference held on 23 April that assistance would be made available only if and when the stability of the euro were in jeopardy.⁵

By early May, things were so bad for Greece that even Merkel's dire conditions had been met and the European Union found itself orchestrat-

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ing bilateral commitments of financial support worth €80 billion over the next three years (with an additional €30bn to come from the International Monetary Fund (IMF)). When she announced the policy, Merkel called it a 'last resort' and an 'emergency situation', and said that 'Greece in fact had no more access to international financial markets'.⁶ She was right.

Merkel's statements may be understandable in the context of domestic German politics, but her policy toward Greece was folly in many senses of the term. It failed to anticipate the speed with which, and the extent to which, the Greek crisis would spread. It cost much more than immediate support to Greece through its painful fiscal consolidation would have cost. And it reinforced stereotypes and prejudices that obscure the true weakness at the heart of the European Union and its single currency.

It wasn't supposed to work like this

Europe's economic and monetary union was supposed to include only those countries that were able to sustain the rigours of price stability. The convergence criteria worked out in the 1992 Maastricht Treaty all pointed in that direction. Economists warned that other criteria for real economic compatibility should also be observed: countries that participate in a common currency should have flexible markets for labour and capital, they should trade extensively with one another, they should follow much the same business cycle, and they should not be subject to what economists refer to as 'asymmetric demand shocks', or sudden declines in demand in the outside world for a country's exports. At minimum, such countries should agree to share a certain amount of fiscal resources across their national borders so that any one country's gain could at least partially offset another country's loss. These arguments are well-rehearsed in the literature, as are the standard objections: European markets are not flexible enough, European business cycles are uncoordinated, and national economies are too vulnerable to asymmetries emanating from abroad. Worst of all, the countries of Europe are unwilling to share their fiscal resources. They do not belong in a single currency and they refuse to do anything about it.

There is considerable merit in each of these arguments, but they do not describe the situation in Greece. The problem there is much simpler. A small

country borrowed itself into trouble without any sanction from European authorities and with few, if any, penalties in the market. Moreover, it did so simply because it could, or rather, because not doing so would have been more difficult. Greek politicians wanted to borrow money rather than make difficult spending cuts or tax rises, and that money was freely available. The reason is that, beyond all the complicated arguments about nominal convergence as per the Maastricht Treaty or 'optimum currency areas' in the debate among economists, a country that joins a monetary union no longer faces a balance-of-payments constraint. It does not have a currency and so it can no longer be threatened with a currency crisis. Greece is not like Argentina in this respect. As a result, fiscal problems can build up much more extensively, because the trigger for a run on the country's debt is not the threat of devaluation but the real prospect of default. By that time, however, the problem is no longer limited to the small country; it belongs to the monetary union as a whole. Few of the standard criticisms of Europe's economic and monetary union expressed serious concern for this prospect.⁷ Even the more extreme criticisms did not make it the focus of their attention.⁸ Exclamations of 'I told you so' from the great economists deserve close scrutiny before they are accepted. Merkel's own fury about the Greek situation deserves greater scrutiny as well.

Moral hazard and legal requirements

Merkel did have some reasonable arguments on her side. The most important is her concern for moral hazard, or the possibility that governments might take advantage of the low cost of borrowing in the eurozone to build up an unsustainable level of indebtedness, just as Greece did. This has been a problem with the single currency since the start. As I argued in 2003, 'if there is a dilemma posed by EMU, it ... is not that countries will be unable to manage their economies, but rather that they will take advantage of their relaxed current account constraints and strengthened credit-worthiness to run excessive deficits'.⁹ The Maastricht Treaty included only two bulwarks to hold back that threat: one was the excessive deficit procedure, which was supposed to prevent countries from borrowing more than they could manage; the other was the 'no bailout rule', which was supposed to make

it clear to member states that they would each be responsible for cleaning up their own mess. In October 1993, the German High Court in Karlsruhe reinforced these with a third constraint. Should Europe's economic and monetary union fail to sustain price stability, German citizens could levy a complaint against their country's participation in the single currency. The Stability and Growth Pact (which is now largely synonymous with the excessive-deficits procedure) was negotiated in the shadow of the German court decision as a means of institutionalising the member states' collective commitment to self-restraint.

There was an alternative solution, which would have been to reduce membership in Europe's economic and monetary union to a core group of like-minded countries.¹⁰ The problem was that so few countries actu-

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to fiscal discipline
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ally qualified to participate in the single currency according to the Maastricht criteria. The first deadline to start the euro in 1997 was missed; the second deadline in 1999 allowed for no further delay. And faced with the choice between a very small single currency and a large one, the European Union leaders took the decision to start with 11 member

states. Of those countries that wanted to join, only Greece was held out of the initial project for failing to meet the criteria. Nevertheless, it was able to join shortly before common notes and coins were issued.

The larger eurozone depended on the Stability and Growth Pact and the 'no bailout clause' to maintain fiscal discipline and promote consolidation. During the early 2000s, however, this collection of institutions and procedures began to unravel as the political commitment that underpinned them fell apart. This was due in some measure to complaints among economists that the pact was too limiting; to an even greater extent it was a result of the recession that took hold in Europe in 2002 and 2003. Disciplining Ireland is one thing; doing the same thing (or worse) to France and Germany is another. In November 2003, France and Germany worked together to set aside the excessive-deficits procedure and in March 2005 the European Council reformed the Stability and Growth Pact.¹¹ Along the way, the commitment to fiscal discipline has weakened even as member states made great

strides in consolidating their public debts. Once the crisis struck in 2008 and 2009, the lack of commitment more than outweighed any past efforts at consolidation. As governments struggled to stabilise their banking systems and stimulate their economies, decades of progress in paying down public debts was erased as if overnight.

A combined economic and financial crisis like the one experienced in 2008–09 has a powerful effect on government fiscal accounts, particularly when measured as a ratio to gross domestic product. Part of this effect is automatic and affects both the numerator (a government's fiscal deficit) and the denominator (a country's gross domestic product) in the ratio. Deficits increase as the contraction in economic activity reduces revenues and increases outlays for unemployment and other benefits; gross domestic product declines as the rate of output contracts. As the two parts of the ratio move in opposite directions, it is small wonder that the number increases so dramatically. Then there is the problem of bank bailouts, which is more relevant to countries like Belgium or the United Kingdom than to Greece. Money transferred from the state to prop up the banking industry goes straight on to the national debt (without making its way through the deficit statistics, because it is technically an asset transfer rather than an expenditure). As a result, the debt suddenly increases as national output diminishes, raising the debt-to-GDP ratio precipitously.

No one in Europe is (or should be) happy with this situation, and increasing voices have called for a re-commitment to fiscal discipline, with Greece as the test case. In 2009, the Council of Economics and Finance Ministers dealt more harshly with Greece than with other countries in fiscal difficulty. The European Commission has made strong pronouncements about the need for Greek austerity as well.¹² Merkel has been at the forefront of these efforts, but she has not been alone. The question is whether she was right to use her leadership to drive this agenda, with this country, at this particular point in time.

Cost and contagion

The Greek sovereign-debt problem in European financial markets did not have to worsen or spread. A strong message from Merkel in November or

December of 2009 that Greece would be supported in refinancing its existing bonds and meeting its new financial requirements would have been sufficient to avert the catastrophe (provided, of course, that Greece stuck to its own consolidation programme and managed to meet its fiscal targets). This assertion is based on a counterfactual that can never be proven, and depends on the faith that Greece might at last live up to its obligations. Neither of these is easy to demonstrate (although it is heartening that the Greek parliament passed austerity measures demanded of it in early May). Nevertheless, there are at least three reasons to believe that things would have been much better if Merkel had used her leadership to calm the markets rather than focusing her attention on the problem of moral hazard.

The first reason is a counter-example where a declaration of support may have made the difference. When German Finance Minister Peer Steinbrück

Greece's fiscal situation was no secret

pointed out at a February 2009 meeting in Düsseldorf that 'the [other member states of the eurozone] would have to rescue those running into difficulty', a number of voices criticised him for threatening to violate the EU's 'no bailout rule', but many believe that his assertion had an important calming effect on sovereign-debt markets during the worst months of the global financial crisis.¹³ Bond yields for Greece and Ireland peaked in late January and gradually declined thereafter.

The second reason for believing Merkel's lack of support made a difference is that the parlous state of Greece's fiscal situation was no secret, and neither were the country's poor accounting practices.¹⁴ Even before the incoming Socialist government had to submit revised accounts, it was clear that only a major fiscal consolidation could avert a crisis in the country's public finances. High debt and deficit levels were the excuse that Standard & Poor's used when they started downgrading Greek sovereign debt in January 2009, citing 'a structural weakness in fiscal management'.¹⁵ Over the course of the year, the problem got worse, not better. Economists from the IMF said this explicitly in their 30 June 2009 report drafted in preparation for their annual Article IV consultations and published in August. Their

analysis was focused. The cover sheet stated that 'fiscal consolidation cannot be postponed ... Greece needs a coherent fiscal adjustment path, based on durable measures, aimed at returning the debt ratio to a downward trajectory. Revenue enhancements are needed, but the main tasks are to address the wage bill and structurally worsening entitlement programs.'¹⁶

The IMF staff also cautioned that Greek representatives were using more optimistic macroeconomic estimates than they could support. Worse, they questioned the underlying quality of Greek fiscal data:

Staff is concerned that large and growing data discrepancies (including 'stock-flow adjustments') between cash accounts and those of the [Stability and Growth Pact (SGP)] could harbor a worse underlying deficit than currently reported. These data shortcomings are a recurring problem in Greece, with interlocutors noting that the debt consistently rises faster than indicated by the SGP deficits reported to Eurostat. Restoring confidence requires durable consolidation and improved accounting systems that allow the authorities to respond in a timely way to slippages and the publication of more stable fiscal indicators.¹⁷

Nevertheless, despite the obviously deteriorating state of Greek public finances (and the explicit concern expressed about national plans and estimates) – Greek ten-year sovereign bond yields fell back from their high levels in the early months of 2009 to stabilise at somewhere between 4.5–4.8% from the end of July through the end of October. What changed when Greece restated its accounts to the European Commission was simply a quantification of this accounting uncertainty. What made the difference for bond markets, however, was the new uncertainty about whether Greece would find political support.

The third reason to believe in the importance of political support lies in the distinction between stocks – not as in 'stocks and bonds' but as in great piles of things – and flows, which are the movements into and out of the piles. Greece has a huge stock of debt. It also has a very large deficit, which is a flow of new debt into the existing pile. And it has a large debt-servicing requirement, which is the flow of expenditure to pay the interest on the

stock of debt. Finally, part of the existing stock of debt matures and so needs refinancing. This is a flow of old debt into new debt.

The stock of debt by itself is not what matters. If you have a huge pile of debt but do not have to pay any interest on it, it is not as much of a problem as a small pile of debt where the interest charges are high. Anyone with a mortgage and a credit card can understand this distinction. The same logic applies to governments. Japan, for example, is not in crisis at the moment even though its ratio of public debt to gross domestic product is almost twice as high as that of Greece.¹⁸

The flows (the creation of new debt, the servicing of existing debt, and the conversion of old debt into new debt) are what count. If Greece cannot raise money to cover its expenditures, if it cannot service the borrowing that it has, and if it cannot retire mature debt by issuing new bonds, it will necessarily default. What is more, a breakdown of any of these flows can trigger a crisis. Debt-servicing requirements or interest payments are the least problematic, because other expenditures can be reduced to offset them. New financing is more complicated and depends to a great extent on the scale of the revenue shortfall. Paying off debt as it matures is the most complicated.

At the beginning of 2010, Greece had little difficulty raising new debt. On 25 January it went to market looking to raise approximately €3–5bn and came home with €8bn, because it faced demand for its bonds worth roughly €25bn.¹⁹ The same thing happened in early March, when the Greek government looked for €5bn and found bids for just under three times that amount.²⁰ Finally, it happened again in April, shortly after the European Union held out the promise of conditional support. Greece came to the market looking for €1.2bn in short-term credits, found close to €8bn in offers, and went home with €1.5bn instead.²¹ Nor was debt servicing the major problem. Although the Greek government complained loudly about the yields necessary to attract attention to these new issues, they were broadly comparable to much of the debt it was retiring and so would not create problems until well into the future as the stock of debt to be serviced continued to mount.

What precipitated the crisis was not new financing or servicing, but the flow of old debt into new bonds. Specifically, markets worried that the Greek government would have trouble refinancing. Just under €8.1bn in bonds were

to come due on 19 May 2010, with another €400 million maturing fewer than two weeks later. Both of these existing tranches of debt carried very high coupons (or fixed interest payments) of 6%. Refinancing them at a similar rate of interest would not be a problem. A failure to refinance would.

A staunch commitment from European governments to support Greece would have eliminated concern about Greece's ability to refinance its debt. Indeed, it is not unreasonable to expect that the May issues would have attracted just as much demand as those brought to market in April, March and January. By insisting that Germany would support Greece only once it was unable to access the market, however, Merkel fuelled concerns that Greece would not meet its refinancing targets. Many began to speculate that Greece might even default, most likely by forcing bond holders to extend the length (in time) of their obligations but possibly by renegotiating the price of the bonds on redemption as well. This explains why there was a sell-off of existing Greek bonds in secondary markets. Merkel inadvertently called into question Greece's ability to manage its all-important flows.

False stereotypes and true villains

The immediate reaction to the crisis from many quarters has been a call for Greece to leave or be kicked out of the eurozone. Some of this is driven by the belief that a devaluation would help Greece restore its competitiveness.²² Much more draws on cultural stereotypes that portray lazy, corrupt, tax-avoiding, spendthrift Greeks as the villains who brought the eurozone to ruin.²³ These stereotypes may be over-represented in the media, but popular resentment toward the Greeks runs deep. In February 2010, a survey showed that 53% of Germans wanted Greece to be kicked out of the eurozone.²⁴

It is tempting to believe that the Greeks lived beyond their means and so deserve their fate. This is true particularly when the conversation turns to corruption or tax evasion. Nevertheless, the data do not paint a coherent picture of mis-, mal-, or non-feasance. Whatever the state of Greek public finances, the Greeks themselves are hard working and relatively frugal, particularly when compared to the Germans. According to data published in the OECD's annual employment outlook, the average Greek worked 2,120 hours in 2008 while the average German worked only 1,432. Much, but not

all, of this disparity is due to part-time employment. Over 22% of Germans worked part time in 2008, while fewer than 8% of working Greeks put in less than a full week.²⁵ The Greeks also tend to leave the workforce at an older age than Germans, despite the fact that Greeks can retire on full pensions much sooner. In 2007, for example, Greek men could retire on a full pension at 58 but instead chose to stay in the workforce until, on average, age 62.4. By contrast, German men retired at 62.1 on average even though they needed to stay in employment until 65 to qualify for a state pension.²⁶

How can this difference in employment be explained? Germans make more money and so can afford more leisure. In current US dollars, the average German made \$43,025 in 2007 while the average Greek made just \$28,424. Life is more expensive in Germany than in Greece, but even accounting for the difference in relative prices the gap in pay is \$8,363 in price-adjusted dollars, or about 30% of an average Greek annual income.²⁷ Germans also have access to more credit. At the end of 2006, German households had outstanding consumer credit, loans and mortgages worth 192% (or almost two times the value) of their household net disposable income; for Greek households that figure was just 112%.²⁸

The other temptation is to believe that the Greeks are in this dire situation because they have priced themselves out of world markets. The IMF stressed this point in the 2009 Article IV report. Moreover, it is true that inflation has been higher in Greece than elsewhere in the eurozone, in terms of both prices and wages. What is not clear is how this relatively high rate of inflation has affected Greek competitiveness in any sense but the narrowest focus on relative prices. Greek relative real unit labour costs have gone down, not up, since joining the single currency, and in 2008 relative real unit labour costs had fallen by even more in Greece than they had in Germany.²⁹ Meanwhile, Greek exports grew rapidly and its share of key export markets expanded.

This export growth is best measured in real (price-deflated) terms, because the price of Greek exports has increased significantly since it joined the eurozone (which is what has economists so worried). Once that increase in prices is removed, however, Greek exports grew 27% in real terms over 2001–08. This is slightly less than the 30% growth rate for the eurozone as

a whole, but that difference is only due to the remarkable performance of Germany (up 46%). By contrast, French exports grew by only 14% in real terms and, outside the eurozone, UK exports grew by 24%.³⁰

The data for market share are based on nominal rather than real exports. What they measure is how much Greece sold into a given market compared to everyone else. For example, according to the IMF's *Direction of Trade Statistics*, Greece accounted for 0.25% of total exports to the European Union (EU) when it joined the euro in 2001 and 0.26% in 2008, a modest rise held back by competition from outside the EU. These figures are obviously very small. Greece never exported much either in absolute terms or as a ratio to its own gross domestic product. Nevertheless, the size of the exports is less important than the change in the market share if we are to assess the country's competitiveness within the eurozone. Where we should expect a decline, what we find is a slight increase. Focusing only on European exports to the EU, the improvement is more significant: Greece accounted for 0.36% of European exports to the EU in 2001 and 0.41% in 2008. Moreover, the picture is the same if we look at Greece's share of the US market. Although Greece's share of total exports to the United States is roughly constant at 0.05%, its share of European exports to the United States increased from 0.25% in 2001 to 0.35% in 2008.³¹

Greeks work hard, earn little and export more now than ever. Nevertheless, they suffer from relatively high rates of inflation and disastrous public finances. In turn, government deficits overwhelm domestic savings. As a result, Greece exports a lot but imports much more. The problem is not the Greek people but the Greek government. One might think they should 'vote the bums out' and bring in someone to clean up the mess. And they did, which is where this story started. Socialist leader George Papandreou campaigned with the promise that fiscal stimulus would lead the country out of its recession.³² What he discovered once in office was that austerity would dominate his economic agenda.

Truth and consequences

Once we begin to empathise with the Greeks rather than simply condemning them, it becomes easier to recognise the need not just to express

solidarity but to share in the blame. This applies not just to Germany but to other export-led-growth-dependent countries like China. The real problem in the eurozone lies not in Greek indebtedness but in the wider structure of savings and investment across the zone as a whole, or what economists refer to as macroeconomic imbalances.³³ If Greece borrowed excessively, it was at least partly due to the fact that other countries were keen to find high-yield investments where they could park their lending. Some of that money went into sovereign debt. That is why Greek bond yields came down in 2009 and why new offers of Greek bonds were so heavily oversubscribed in 2010. Everyone knew the poor state of Greek government finances, but the interest rates Greece was prepared to offer were too attractive to ignore. More

Panic among lenders is the source of the contagion

foreign lending went into the Greek banking system, where the possibilities for recycling eurozone deposits into high-yielding domestic investments were better than elsewhere.

Merkel was right to insist that the euro can only survive if there is credible market discipline. Moral hazard is a danger. What she misunderstood is that discipline cannot be the responsibility of the borrower alone.

Greece is the borrower; Germany is the lender, and this lending is an essential counterpart to Germany's export-led-growth strategy. If Germany wants to grow by selling to the rest of the world, it must also provide the rest of the world with the money to buy German exports. The more Germany succeeds as an export powerhouse, the more its stock of lending to foreigners like Greece is sure to pile up. When Merkel refused to support Greece in its efforts to keep open its access to credit markets, she failed to recognise that these actions threatened lenders as well. The French and German banks that hold Greek sovereign instruments suddenly saw a threat to the principal of their investments. Worse, they recognised that this threat extended to the whole of the Greek banking sector and to other highly indebted countries.

Panic among lenders is the source of the contagion. That panic is what has caused the spike in Portuguese and Spanish bond yields, the decline in their stock markets, and the run on deposits from Greek banks. Moreover,

the longer panic is allowed to fester, the more it will cost to restore calm. If Merkel had from the start given a full-throated promise of support to the new Greek government – the one that the Greeks voted in to kick the bums out – lenders would not have felt threatened. They would have held on to their investments and continued to chase relatively high Greek yields. This would have given the new government the breathing space to make the necessary (and extremely painful) fiscal consolidation.

A promise to support Greece in its efforts to maintain access to credit markets would have cost Germany nothing in practice, but it would have stabilised the eurozone and laid the foundations for greater stability in the future. By refusing to back Greece, however, Merkel created uncertainty and scared off investors. She also made sure not only that Greece would fail but also that Germany would pay. More importantly, she helped nurture a wider crisis of confidence in both sovereign-debt markets and in the euro itself. She may have had strong domestic reasons for taking this action, but it was a mistake.

It is vital that Merkel now shows true European leadership. As the Green Party Faction leader Jürgen Trittin put it in a widely quoted article in *Der Spiegel*, the situation calls for '*weniger Stammtisch, mehr Helmut Kohl*'.³⁴ His rough meaning was 'less populism, more statesmanship'; the basic point being that the interests of Germany and of Europe are inseparable. By taking a populist line, Merkel failed to recognise the logic of that interdependence, a logic that her Christian Democratic predecessor Helmut Kohl understood all too well. Moreover, Germany cannot make its Greece problem go away simply by expelling Greece from the eurozone. If anything, efforts to ignore or isolate Greece only make matters worse for all parties. The focus has to be on how they can live prosperously together. Greece must get its fiscal house in order, but Germany must change as well. Accepting the necessity for European solidarity is only part of the answer. Finding a real solution to the problem of moral hazard and macroeconomic imbalances is the rest.

Where do we go from here?

The EU member states took action to stop the crisis from spreading out from Greece. The countries of the eurozone agreed in early May to a €110bn fund of

bilateral loans, including €30bn from the IMF, to take Greece out of the bond market. Nevertheless, financial actors worried that this would be insufficient and began to panic anew. Bond yields shot up in the Southern European countries, Spain and Portugal in particular, even as stock markets fell across the globe. European leaders met again the following weekend to agree an even more ambitious programme, with €500bn in bilateral loan guarantees and balance-of-payments support backed by as much as €250bn in IMF loans. Meanwhile, the European Central Bank announced it would intervene in bond markets directly, stabilising prices by purchasing existing debt.

These measures may calm the markets temporarily but they will not solve the underlying problem. So long as countries in the eurozone can borrow without market sanction, politicians will find a way to dig themselves unsustainably into debt. Threatening them with sanction is no solution either. As the history of the Stability and Growth Pact has shown, the turkeys find it hard to vote for Christmas, particularly when they know their turn at the block may be next.

The best way forward is to place restrictions on access to credit rather than trying to control the build-up of debt. This can be done for governments just as it is for households, by differentiating between the instruments used to access credit. One method would be the creation of common eurobonds jointly underwritten by the participatory countries of the eurozone, which governments could use to access credit markets for up to 60% of their annual income; they would have to issue national paper to cover the rest. Moreover, these common bonds could have a 'super senior' status, meaning that the governments would have to agree to meet their financing needs first. That way everyone in the bond markets would know that national paper would be the riskiest because that is where governments would look first to restructure or default. Since risk trades at a premium, the market would provide the discipline. Responsible borrowing through eurobonds, meaning any borrowing up to 60% of GDP, would be relatively cheap. Excessive borrowing, which would have to take place through national bonds, would come at a much higher cost.

Fully developed versions of this proposal have already been made independently by at least three different think tanks.³⁵ Now it is time for

governments to show the courage to bring this about. It is a short step from a special-purpose vehicle backed by bilateral loan guarantees (which is what the current bailout measures rely upon) to a European bond. Merkel made a mistake in downplaying the seriousness of the Greek situation and deferring an appropriate response. Now she has a chance to support a proposal that can prevent moral hazard and avoid the prospect that this enormous financial-assistance package will all be for naught.

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Notes

- ¹ The crisis in Greek fiscal accounting emerged in October 2009, when the government submitted its fiscal projections to the European Commission as required under the Stability and Growth Pact. The outgoing New Democracy government sent a report on 2 October indicating that the ratio of the government deficit to gross domestic product (GDP) was 5.0% in 2008 and was expected to decline to 3.7% in 2009. The incoming Pan-Hellenic Socialist Movement (Pasok) government sent a revised report on 21 October claiming that the actual deficit for 2008 was 7.7% of GDP and the expected deficit for 2009 was likely to come out at 12.5%. This was hardly the first time that a Greek government had revised its data to discredit its predecessor and to make the situation look worse than expected. New Democracy did the same to Pasok when it came to office in 2004. The difference this time was that Greece's European partners refused to accept that the problems were specific to the government rather than being a reflection of the chronic weakness in Greek data-collection procedures, particularly as regards fiscal policy. Meeting in November, the Council of Economics and Finance Ministers rejected incoming Prime Minister George Papandreou's attempts to lay all the blame on his predecessor. This was followed in early January by a European Commission report condemning the poor state of Greek fiscal statistics. See Tony Barber, 'Greece Condemned for Falsifying Fiscal Data', *Financial Times*, 12 January 2010.
- ² 'Pressekonferenz der Bundeskanzlerin nach dem Europäischen Rat', 11 December 2009, http://www.bundeskanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2009/12/2009-12-12-pk-bk-bruessel.html.

- ³ 'Statements von Merkel und Sarkozy', 11 February 2010, http://www.bundestkanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2010/02/2010-02-11-pk-europaeischer-rat.html.
- ⁴ 'Pressekonferenz der Bundeskanzlerin nach dem Europäischen Rat', 26 March 2010, http://www.bundestkanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2010/03/2010-03-26-pk-bk-bruessel.html.
- ⁵ 'Pressestatement von Bundeskanzlerin Angela Merkel zum Antrag Griechenlands auf Finanzhilfe', 23 April 2010, http://www.bundestkanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2010/04/2010-04-26-statement-griechenland.html.
- ⁶ 'Pressestatements von Bundeskanzlerin Merkel und Bundesaußenminister Westerwelle', 3 May 2010, http://www.bundestkanzlerin.de/nn_683698/Content/DE/Mitschrift/Pressekonferenzen/2010/05/2010-05-03-statement-griechenland.html.
- ⁷ Charles Wyplosz mentions the risk of borrowing to default but then suggests that it has not materialised as a significant threat, although he cautions that 'time will tell'. See Charles Wyplosz, 'European Monetary Union: The Dark Side of a Major Success', *Economic Policy*, vol. 21, no. 46, April 2006, pp. 225, 238.
- ⁸ See for example Martin Feldstein, 'The Political Economy of the European Economic and Monetary Union', *Journal of Economic Perspectives*, vol. 11, no. 4, Autumn 1997, pp. 23–42; Martin Feldstein, 'EMU and International Conflict', *Foreign Affairs*, vol. 76, no. 6, November–December 1997, pp. 60–73.
- ⁹ Erik Jones, 'Liberalized Capital Markets, State Autonomy, and European Monetary Union', *European Journal of Political Research*, vol. 42, no. 2, March 2003, pp. 111–36.
- ¹⁰ This was proposed by Wolfgang Schäuble and Karl Lamers in 1994.
- ¹¹ See Erik Jones, 'European Macroeconomic Governance', in Jeremy Richards (ed.), *European Union Power and Policymaking*, 3rd ed. (London: Routledge, 2006), pp. 329–49.
- ¹² See Dermot Hodson, 'The Euro Area in 2009: The Financial Crisis Gets Real', *JCMS Annual Review*, forthcoming. Many thanks to Dermot Hodson for sharing this manuscript.
- ¹³ Bertrand Benoit and Tony Barber, 'Germany Ready to Help Eurozone Members', *Financial Times*, 18 February 2009.
- ¹⁴ Greece's accounting difficulties stretch far back to its pre-euro membership days. See James D. Savage, *Making the EMU: The Politics of Budgetary Surveillance and the Enforcement of Maastricht* (Oxford: Oxford University Press, 2005), p. 137.
- ¹⁵ Sam Jones, 'S&P Downgrades Greece', Alphaville (FT blog), 14 January 2009, <http://alphaville.ft.com/blog/2009/01/14/51146/sp-downgrades-greece/>.
- ¹⁶ *Staff Report for the 2009 Article IV Consultation* (Washington DC: IMF, 30 June 2009), <http://www.imf.org/external/pubs/ft/scr/2009/cro9244.pdf>.
- ¹⁷ *Ibid.*, pp. 20–21.
- ¹⁸ This point about debt-to-GDP ratios is important to remember as Greece's

problems spill across its borders and begin to threaten Spain and Portugal. Just because the Iberian countries have much lower stocks of debt, does not mean they will find it any easier to maintain the necessary flows.

- ¹⁹ This story was carried on the AP wire. See, for example, 'Greek Bond Issue Oversubscribed', *Straits Times*, 26 January 2010, http://www.straitstimes.com/BreakingNews/Money/Story/STIStory_482136.html.
- ²⁰ Michael Wilson and Costas Paris, 'Greece's Bond Offer Gets Good Response', *Wall Street Journal*, 4 March 2010, <http://online.wsj.com/article/SB10001424052748704187204575100922786384954.html>.
- ²¹ 'Greece Treasury Bill Oversubscribed', *France24*, 13 April 2010, <http://www.france24.com/en/20100413-greece-treasury-bill-issue-oversubscribed>.
- ²² See, for example, Paul Krugman, 'A Money Too Far', *New York Times*, 7 May 2010.
- ²³ This kind of argument was all over the media. For a recent sample, see Harry de Quetteville and Paul Anast, 'Revolution from Greece's Ruins as Crisis Deepens', *Telegraph*, 1 May 2010, <http://www.telegraph.co.uk/news/worldnews/europe/greece/7664764/Revolution-from-Greeces-ruins-as-crisis-deepens.html>.
- ²⁴ Edmund Conway, 'Most Germans Want Greece Thrown Out of Euro', *Telegraph*, 14 February 2010, <http://www.telegraph.co.uk/finance/currency/7238035/Most-Germans-want-Greece-thrown-out-of-euro.html>; see also 'Germans say Eurozone May Have to Expel Greece: Poll', *Reuters.com* 14 February 2010, <http://www.reuters.com/article/idUSTRE61DoZC20100214>.
- ²⁵ See *OECD Employment Outlook 2009* (Paris: Organisation for Economic Cooperation and Development, 2009) pp. 267, 269. The OECD cautions against making the comparison between total hours worked across countries both because of the differences in how these data are collected and because of treatment of part-time workers.
- ²⁶ *Society at a Glance 2009: OECD Social Indicators* (Paris: Organisation for Economic Cooperation and Development, 2009), Table SS6.1. Note that Greek and German women retire at relatively comparable ages: 60.9 and 61 respectively. Once again, however, the Greek women are retiring beyond eligibility for a state pension while the German women are retiring early.
- ²⁷ *OECD Employment Outlook 2009*, p. 275.
- ²⁸ The borrowing data come from the European Central Bank; the net disposable household income data come from the AMECO dataset of the European Commission.
- ²⁹ The relative real unit labour costs data come from the AMECO dataset of the European Commission. When economists talk about competitiveness, they mean relative prices. Hence a competitiveness problem for economists is an adverse movement in relative prices. By this definition, Greece definitely has a competitiveness problem because prices went up more quickly in Greece than elsewhere. Many thanks to Waltraud Schelkle for driving this point home for me. What is at issue is whether this is really

the most meaningful understanding of the term 'competitiveness'. See Paul Krugman, 'Competitiveness: A Dangerous Obsession', *Foreign Affairs*, vol. 73, no. 2, March–April 1994, pp. 28–44.

- ³⁰ These real export growth data are calculated using level data from the AMECO dataset of the European Commission.
- ³¹ As indicated in the text, these data come from the *Direction of Trade Statistics* of the IMF.
- ³² See 'Greek Socialists Win Snap Poll', BBC News, 5 October 2009, <http://news.bbc.co.uk/1/hi/8289674.stm>.
- ³³ This was the focus for my concern in 'Liberalized Capital Markets, State Autonomy, and European Monetary Union'. For an update on that argument, see Erik Jones, 'Shifting the Focus: The New Political Economy of Global Macroeconomic Imbalances',

SAIS Review, vol. 29, no. 2, Summer–Fall 2009, pp. 61–73.

- ³⁴ 'Weinger Stammtisch, mehr Helmut Kohl', *Der Spiegel*, 1 May 2010, <http://www.spiegel.de/politik/deutschland/0,1518,692458,00.html>.
- ³⁵ John Springford, 'Strengthening the Stability and Growth Pact with a Common Eurozone Bond', CentreForum, September 2009, <http://www.centreforum.org/assets/pubs/stability-and-growth.pdf>; Erik Jones, 'A Eurobond Proposal to Promote Stability and Liquidity while Preventing Moral Hazard', ISPI Policy Brief, No. 180, March 2010, http://www.ispionline.it/it/documents/PB_180_2010.pdf; Jacques Delpla and Jakob von Weizsäcker, 'The Blue Bond Proposal', Bruegel policy brief, May 2010, <http://www.bruegel.org/publications/show/publication/the-blue-bond-proposal.html>.