

# **In What Form Will the Eurozone Emerge from the Crisis?\***

Franklin Allen  
University of Pennsylvania

and

Victor Ngai  
University of Pennsylvania

August 20, 2012

## **Abstract**

The Eurozone is in the midst of a deep crisis. We argue that the attempts to control government deficits and debts using the Stability and Growth Pact have failed. Moreover, austerity policies are inducing downward spirals in terms of growth. Political leaders have promised deeper political, fiscal and banking union. However, this will take many years to implement. We argue that in the meantime in order to save the euro, allowing default and temporary exit from the Eurozone is desirable as these policies are capable of initiating significant growth in the short run. This will allow Greece and possibly other countries that adopt them to bring down their unemployment, particularly youth unemployment, in a reasonable time frame.

Classification Codes: G12, G15, G18.

Keywords: default, temporary exit, Argentina, growth.

---

\* We are grateful to participants at the *Journal of Applied Finance* Conference in New York on May 11, 2012 and the Wharton Global Alumni Forum in Milan on May 17, 2012 for their helpful comments and suggestions.

## **1. Introduction**

In the mid 2000's the euro project was acknowledged by many to be a great success. Wide and deep corporate bond markets had developed, the euro was increasingly used as a reserve currency by central banks, and sovereign debt spreads did not differ much across the different member states. Many countries in the European Union were keen to join the Eurozone. However, the financial crisis that started in 2007 has changed all of this. The default of Lehman Brothers in September 2008 led to recessions and large budget deficits in many countries. The bursting of property bubbles in a number of countries such as Ireland and Spain at about the same time put banks under strain.

At the end of 2009 and beginning of 2010 it became clear that Greece was in serious trouble. In May 2010, Greece became the first Eurozone country to seek help from the International Monetary Fund and the European Union. This was followed by the creation of the European Financial Stability Facility (EFSF), a private company with debts guaranteed by Eurozone governments to provide finance to Eurozone countries needing a bailout. A few months later, in November 2010, Ireland also sought help and was followed by Portugal in April 2011. In March 2012, Greece was granted more help and was allowed to default on debt held by the private sector but not on the debt held by the public sector. In 2012 Spain and then Cyprus sought help. Although it has not applied for a bailout, Italy is under considerable pressure, with the spreads on its 10-year government bonds relative to German 10-year bonds frequently above 5%. The EFSF is a temporary measure due to expire in 2013. The European Stability Mechanism (ESM) was agreed on by Eurozone governments in December 2010 and is designed to be a permanent replacement for the EFSF. It was originally supposed to come into existence in July 2012 but as of the time of writing in August 2012 this has not happened.

The stresses and strains of the crisis have thus revealed severe weaknesses in the design of the Eurozone. From the time the project was first discussed, there were always worries that some countries would abuse the system and behave in a fiscally irresponsible manner. The Stability and Growth Pact (SGP) was introduced in 1997 to curb this problem. It has many provisions described in detail below, but the main two were that countries should keep their government deficit below 3% of GDP and government debt should not go above 60% of GDP. As the time for the introduction of the euro approached, it became clear that Belgium and Italy would not satisfy the debt rule. They were nevertheless allowed to join on the grounds that their debt to GDP ratio was moving downwards. Greece was allowed to join two years after the original formation of the euro on January 1, 1999.

Although it had been a staunch advocate of the SGP, in the early 2000's Germany was the first country to violate it and was soon after followed by France. In November 2003 the European Commission presented evidence to the Council of the European Union that both countries were in violation of the SGP. Political pressure from Germany and France on other countries led to the suspension of the pact in 2004 and no penalties were enacted. In 2005 the SGP was changed to lengthen deadlines for countries to take action on deficit levels, to allow longer adjustment periods and loosen escape clauses.

Despite these changes, in the years before the crisis struck in 2007, all countries in the Eurozone were at some point in violation of the 3% deficit rule except for Luxembourg and Ireland. However, no countries were penalized. The effect of the crisis was large in all countries. Based on 2011 data, only four countries in the EU were in full compliance with the SGP deficit and debt criteria: Estonia, Luxembourg, Finland and Sweden. Despite these widespread violations of the SGP, no countries have been penalized at any stage.

The SGP has been a failure in disciplining countries. With 5 out of 17 countries now being in bailout programs, and Italy facing very high spreads that may force it to seek a bailout, there are widespread concerns about the future of the euro. The problem is the EFSF is not big enough to provide the funds that Italy would likely need. The same is true for the ESM when all countries finally ratify the Treaty clause that creates it. The response of politicians initially was to try to strengthen the SGP. However, given its failure in the past it seems unlikely that it will succeed in the future. More recently leaders have promised greater political and fiscal integration and a banking union. The problem with these reforms is that they are much more far-reaching than anything introduced so far and will take many years to implement. The experience with the ESM is instructive here. Despite being relatively simple and having the EFSF as a model, it has not been set up after one year and eight months. Given the short-term problems it faces, the Eurozone is in danger of a run on the debt or banks of one or more countries that could lead to pressures for a breakup.

In this paper, we argue that what is needed to save the euro is to allow countries to default and in extreme circumstances to **temporarily** leave the Eurozone. At the moment, the countries in trouble have GDPs that are shrinking or growing very slowly. Attempts to cut government deficits through austerity plans are not proving successful. Instead, they slow growth further, which then means more cuts are required. Although there is much discussion of growth policies, the kinds of measures suggested take many years to have an effect. Improving product market competition appears to have effects on growth in three to five years. Labor reforms take longer, more like eight to ten years. Finally, educational reforms take even longer than this to have significant effects. We argue that the possibility of default and devaluation are much more effective short-term growth strategies. One example is Argentina, which started

growing soon after it defaulted on its debt and devalued its currency. We also discuss countries that left the Gold Standard in the 1930's, South Korean versus Japanese experience in 2008-9, and Finland's emergence from its financial crisis in the early 1990's.

Section 2 considers the history of SGP. Section 3 discusses previous experience with default and devaluation. Section 4 considers Greece's possible default and temporary exit from the Eurozone. Finally, Section 5 contains concluding remarks.

## **2. The Stability and Growth Pact<sup>1</sup>**

One commonly cited cause for the crisis in the Eurozone is high levels of deficit and debt in numerous European countries following the creation of the single currency. The global financial crisis exacerbated the problem, with debt loads soaring in the "peripheral" countries and their effect spreading across the Eurozone.

The question arises as to whether there was a failure in Eurozone governance and in the implementation of fiscal limits in European Union (EU). The problem of high deficits and debt was in fact foreseen by the drafters of the Maastricht Treaty, who sought to create a common currency that was as stable as the Deutsche Mark. So the foundations for the establishment of the euro were laid out in the Treaty, where certain convergence criteria were defined, most notably limits on government finances, which had to be satisfied by a member state before it is admitted to the third stage of the monetary union. To this end, all EU countries worked for several years to stabilize inflation, lower government spending, reduce debt and avoid devaluation of the currency, in order to achieve the convergence criteria. By 1999, deficit and debt levels declined in most EU countries, and eleven countries qualified for the euro.

---

<sup>1</sup> This section is based on Ngai (2012a, b).

As the launch of the new currency neared, there were discussions to implement a formal framework to maintain fiscal discipline once countries adopted the euro, as they were no longer bound by the convergence criteria in the Maastricht Treaty. Under the Treaty, all member states of the EU were required to “avoid excessive deficits” but with few specific stipulations for enforcement. The Treaty also grants power to the European Commission, the EU’s executive body, and to the Economic and Financial Affairs Council (ECOFIN), made up of economic and finance ministers from member states, to monitor deficit and debt levels and to issue warnings and impose fines as necessary.

The idea of a more detailed set of procedures to handle excessive debts, or a “Stability Pact”, was proposed by German finance minister Theo Waigel in the mid 1990’s. Germany had long maintained a policy that emphasized price stability, which had been an important part of the German economy's strong performance. The German government hoped to ensure the continuation of that policy, which would limit the ability of governments to exert inflationary pressures on the European economy.

The intent of putting in place the Maastricht convergence criteria and a Pact to enforce fiscal discipline was to maintain economic stability within the EU and avoid large divergences across countries that would disadvantage fiscally prudent countries such as Germany. Given the variability of national budgets and the lack of formal budget limits on member states after the adoption of the single currency, and in order to reassure critics of the euro and financial markets, regulations on public finances became indispensable to the functioning and stability of the euro, so as to avoid spillover effects on all Eurozone countries. Since countries needed to forego control of monetary and exchange rate policies, countries were presumed to gravitate towards the use of fiscal policy and excessive fiscal deficits to manage macroeconomic shocks. Financial

mismanagement in a country could reduce market confidence and lead to higher borrowing rates for all countries. Or worse, debt-ridden countries could overspend to a point where they could demand support from other countries. Excessive debt cannot be financed in public markets and can lead to monetary financings by central banks.

The resulting agreement, the Stability and Growth Pact (SGP), was introduced in 1997 as Council regulations, and was designed to strengthen fiscal discipline on deficits and debt levels of member states. Rather than as part of a formal treaty, the SGP was EU secondary law and thus part of a set of European regulations and directives that applied to all member states and was set up to complement the creation of the single currency. Elaborating and supplementing the general provisions in the Maastricht Treaty, the SGP had the purpose of maintaining and enforcing low budgetary deficits in the Economic and Monetary Union (EMU). The SGP was thus intended to safeguard “sound public finances” and ensure that Member states having adopted the euro and met the Maastricht convergence criteria would continue to observe them.

## **2.1 The Details of the Stability and Growth Pact**

As in the Maastricht Treaty, the two major criteria that member states must respect under the SGP are:

- (1) Annual government deficit not exceeding 3 percent of Gross Domestic Product (GDP)
- (2) Government debt not exceeding 60 percent of GDP, or diminishing and approaching that value.

The SGP became the rule-based framework to coordinate national fiscal policies in the EMU. The Pact has two components: a preventive arm and a corrective (dissuasive) arm. Based on the concept of “multilateral surveillance” as established in the Maastricht Treaty, the preventive arm requires member states to submit annual stability programs (for Eurozone

countries) or convergence programs (for countries outside the Eurozone) to the Commission and the Economic and Financial Affairs Council (ECOFIN), showing how they plan to achieve or safeguard sound fiscal positions to meet their budgetary objectives. The Commission then assesses these programs and ECOFIN gives an opinion on them and may make its recommendations public.

The preventive arm includes two policy instruments:

First, in addition to the existing GDP deficit limit of 3 percent, the preventive arm also requires countries to strive for a medium-term objective (MTO). In the original agreement from 1997, countries were urged to attain a common “close-to-balance or in surplus” position to deal with normal cyclical fluctuations, with deficit no larger than half a percent of GDP over the cycle to remain in compliance. This allowed member states a sufficient cyclical safety margin when automatic stabilizers are operated in an economic downturn.

Second, ECOFIN can issue an early warning to prevent the occurrence of an excessive deficit. With the use of official policy advice, the Commission, through ECOFIN, can directly address policy recommendations to a member state with regards to the broad implications of its fiscal policies. ECOFIN can make a recommendation to a member state to take prompt corrective measures if the excessive deficit persists or worsens. The preventive arm had little prominence and did not gain much attention in public debates.

The dissuasive or “corrective” part of the Pact governs the Excessive Deficit Procedure (EDP) created by the Maastricht Treaty. The SGP specifies triggers to the EDP and if it is decided that the deficit is excessive in the meaning of the Treaty, ECOFIN issues recommendations to the relevant member state, providing guidance and a timeline to correct the excessive deficit. ECOFIN abrogates the EDP decision when the excessive deficit is corrected by

the member state. If ECOFIN believes that the member state has failed to comply with the recommendations, it can trigger further steps in the procedures such as requiring publication of information, demanding a non-interest bearing deposit with the EU, or imposing a fine on the country. However, since ECOFIN is composed of ministers from member states, the credibility of the framework is reduced since they are reluctant to impose serious sanctions on other member states.

## **2.2 The 2005 Reform**

Germany, which was much more insistent on maintaining fiscal discipline than other countries, turned out to be one of the first countries to violate the SGP. In 2002, Germany avoided an early warning from the Commission for failing to adhere to the deficit criterion in the SGP and approaching the 3 percent limit for its deficit by striking a deal with ECOFIN. In January 2003, ECOFIN issued an early warning to France to urge it to balance its budget. In November 2003, the Commission presented its findings to ECOFIN, stating that both Germany and France had not taken adequate steps to reduce excessive deficits.

ECOFIN decided not to proceed with action against France and Germany by holding the EDP in abeyance. Political pressure from these two countries led to the effective suspension of the Pact and the EDP was formally suspended in December 2004. Romano Prodi, then President of the European Commission, called the SGP rules “stupid” for being too rigid at a time of economic downturn.

The reform of the fiscal regime was subsequently announced in March 2005, with more “flexibility” for countries to account for running large deficits but the form of the original SGP remained mostly unaltered. Reference values were left untouched since they were part of the Treaties and discretionary powers were extended. The most important changes include revised

medium-term objectives (MTOs) that account for national differences, as well as clarification of “exceptional and temporary” excesses and “other relevant factors”.

Compared to the original SGP that purported to enable the Commission and ECOFIN to react quickly to deteriorations in fiscal policies and to impose sanctions within a year, the 2005 “reformed” SGP loosened the escape clauses, lengthened deadlines for taking action, and expanded the circumstances under which longer adjustment periods are permitted. These parameters include the behavior of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures. No EDP procedure will be launched if the excess of the government deficit over the 3% of GDP reference value is considered temporary and exceptional and the deficit remains close to the threshold.

### **2.3 Deficit and Debt Levels, 1995-2007**

It can be seen from Figure 1 that from 1995 to 2007, only Luxembourg and Ireland managed not to exceed the 3% of GDP deficit threshold throughout the entire period. Nonetheless, before the creation of the euro in 1999, with the exception of Greece, eleven countries sufficiently brought down their levels of deficits below the 3% reference value to meet the convergence criteria. Notably, Finland made substantial efforts to improve its deficit levels. Ireland, which was a country later hit severely by the sovereign debt crisis, held surpluses for almost the entirety of this period and fully complied with the deficit rule. Meanwhile, Germany and Spain made substantial efforts to have fiscal surpluses but several countries, including Greece, Italy, France and Portugal, maintained high deficit levels, especially after admission to the Eurozone.

By the end of 2004, only half of the Eurozone countries had fiscal positions that could be deemed as “close-to-balance or in surplus,” defined as a minimum one-half percent cyclically adjusted deficit. These countries included Belgium, Finland, Netherlands, and Spain. Countries such as France, Germany, Greece, Italy, and Portugal remained far off from their objectives. As a result, these countries ended up posting deficits in excess of 3 percent that pushed them close to triggering the Excessive Deficit Procedure.

Enforcement of the SGP was made more difficult by the fact that several countries, including Greece, Italy, and Portugal underreported their deficit numbers to the European Commission. When the numbers were later revised by Eurostat, the problem was revealed to be more serious, and could possibly have disqualified some countries from joining the euro because of the high level of deficits.

It can be seen from Figure 2 that with respect to debt levels, Belgium, Italy, and Greece had the highest debt loads. Belgium and Italy showed substantial improvement over the period from 1995 to 2007, justifying their claims that they were actively reducing their debt to fulfill the Maastricht convergence criteria and SGP limits. However, Greek debt levels did not seem to decline and increased by about 10 percentage points over the period. Ireland, Spain, Netherlands, and Finland had declining levels of debt since the introduction of the single currency and consistently kept it below 60% of GDP until 2007. On the other hand, countries such as Germany, France, Austria, and Portugal maintained debt levels around the 60% of GDP specified by the Maastricht Treaty. Portugal, although having fulfilled the criterion before its admission, had its debt levels climb steadily, where 60% was surpassed in 2004 and continued to increase.

Overall, the Maastricht convergence criteria had a positive influence for many countries such as Italy, which attempted to bring down its debt and deficit levels prior to joining the euro,

and have maintained consistent levels after adoption. However, with the different set of incentives under the Stability and Growth Pact, there was no significant improvement in deficit and debt levels in many countries. Even though there was a rebound in deficits and debt levels after the 2005 reform of the SGP, most countries' finances did not diverge widely. Countries like France and Germany did not improve their debt levels to bring them into line with the SGP, while countries such as Ireland actively brought them down to healthy levels. Comparing budgetary stabilization efforts before and after the euro, and comparing the change between the Eurozone and the rest of the OECD, the Eurozone countries did not perform better, showing that the SGP has had a limited effect.

#### **2.4 Why the SGP was ineffective**

The enforcement mechanisms that support the SGP could help explain why adherence to the Pact was limited in many countries. The responsibility for enforcing fiscal limits in the SGP fell on two players. The first was the European Commission and ECOFIN. The second was the financial markets, which had the power to affect interest rates on government bonds, thereby signaling their level of confidence with a country's public finances.

In the years following the enactment of the SGP, enforcement was lax due to the lack of financial sanctions imposed on countries despite the inability of many countries to comply with targets, most notably France and Germany. Imposition of sanctions required consent of ECOFIN, composed of national ministers of finance and where France and Germany held a large portion of votes. In other words, member states could easily overturn mechanisms that they devised when their deficit and debt levels did not fall under the previously agreed levels.

When France and Germany decided to impose a looser interpretation of the SGP in 2003 to avoid sanctions, the SGP was no longer fully operative, this being only four years after the

establishment of the single currency. Many warnings and reports were issued by the European Commission on countries' fiscal policies but no action was taken by ECOFIN. Prior to the crisis, an official early warning was issued to France in 2003 only after the 3% of GDP deficit threshold was breached, but not to Germany, Portugal, and Italy, for which the Commission recommended early warnings. Since European institutions were not directly elected, it was also difficult to impose sanctions on national governments that were popularly elected. No fines have ever been imposed on a member state, despite the power of ECOFIN to do so under the dissuasive arm of the SGP.

By 2011, all Eurozone countries had been involved in the Excessive Deficit Procedure (EDP). Although the Commission still argued that the SGP was a framework by which member states could return to sound fiscal policies, few countries adhered to the Commission's recommendations. In addition, since 23 of 27 EU countries were subject to the EDP and many of the EDPs were launched in 2009, the likelihood of any sanctions imposed by ECOFIN on an individual member state was significantly reduced. The inability to enforce automatic sanctions, as Germany had demanded before the introduction of the SGP, is a limit that renders enforcement against countries with excessive deficits or debt difficult.

The political architecture that underlies the SGP could provide an explanation as to why the fiscal rules were not fully enforced. An important factor was creative accounting, notably by Greece, to hide large deficits, leaving the problem undetected for years. National leaders are accountable to their electorate, from whom they face possible political sanction, and this can lead to a general bias towards deficits and debts. Incentives for adherence are thus much weaker at the European level, especially for large countries that have substantial political influence in the EU. An additional factor is a moral hazard problem where the lack of a significant interest rate risk

premium means that the costs of profligacy are small and are shared with the rest of the Eurozone.

Traditionally fiscally conservative countries, such as Germany, Luxembourg, Austria, and Finland, managed mostly to avoid large fiscal deficit until they faced the full brunt of the sovereign debt crisis. By 2009, these countries had hit the deficit range, but managed to maintain near the 3% reference value for deficit levels. In the rest of the Eurozone, with the exception of Greece, most countries managed to maintain their deficit levels low in 2008. By 2009, only Belgium, Netherlands and Italy kept their deficit levels under 5% of GDP, while the rest of the group fell into deficits at or near 10% of GDP. Notably, due to the bailouts of financial institutions by the government of Ireland, the deficit there dipped to 31.3% of GDP.

Furthermore, the assessment of structural balance was often deficient in the first decade of the euro, and in addition to the fact that the effect of changes in the output gap on tax revenues was often incorrectly estimated, there was little attention paid to changes in government revenues that were due to asset cycles in the financial and housing markets, rather than to the general economic cycle. When the crisis hit, countries lost important sources of revenue from those markets and were left with a larger deficit than they otherwise would have had.

Belgium, Greece, Italy, and Portugal, which already had high debt-to-GDP ratios before the crisis, had debt levels increase dramatically during the period, with Greece ending up with a value greater than 160%. An interesting case, however, was that of Ireland. It performed relatively well with the SGP targets prior to the crisis, yet when under pressure to save failing financial institutions, it was forced to be indebted at much higher levels, reaching over 100% of GDP by 2011. The rest of the monetary union saw a steady climb in debt ratios and, with the exception of Finland, went above the targeted 60% of GDP reference value.

Given the economic downturn and the push for stimulus, countries in general ignored the limits set by the SGP as most believed that they were facing one of the worst economic recessions since the end of the Second World War, which would qualify as an “exceptional and temporary” situation.

In the midst of a debt crisis, with bond yields increasing rapidly, the European Commission and ECOFIN did not make an attempt to sanction any country for ignoring the SGP targets, as most of them had breached them. As the debt level for countries such as Greece continued to climb, there were no significant institutional attempts to pressure the Greek government to reverse the change. As bond yields escalated in the market, countries continued to be hit hard with large borrowing costs, at the risk of defaulting.

One of the original intentions of the SGP was to enforce strict fiscal rules and promote prudence in government finances during most of the economic cycle, so that in “exceptional” circumstances, a country would be able to run deficits without falling away from its Medium Term Objective (MTO). Indeed, the global financial crisis had serious repercussions in Eurozone economies and it is questionable whether the SGP could have prevented the precipitous rise in debt levels in cases such as Ireland, a country that was in full compliance with the rules prior to the crisis. However, the general lax enforcement of the SGP in the years before the sovereign debt crisis made any quick return to sustainable deficit and debt levels difficult. This major shortcoming of the SGP meant that its credibility was questioned as countries grappled with the effects of the sovereign debt crisis, and Eurozone countries were widely criticized for their finances.

## 2.5 Market enforcement

As much as the Maastricht convergence and the subsequent Stability and Growth Pact were political agreements among member states, the success of the monetary union depended partly on acceptance in the financial markets. The EU needs to assure investors of the benefits of a common currency and member states need to convince markets that the default risk of their sovereign bonds declined as a result of joining the euro.

After the formation of the single currency, Figure 3 shows that interest rate spreads on long-term government bond yields between Germany and other Eurozone countries were narrow and almost constant. This was in sharp contrast to spreads before. The narrow spreads reflected confidence in the market that participation in the Eurozone reduced the risk of default substantially even in countries that formerly had high levels of government debt and deficit. In addition, financial investors perceived the Commission to be a credible enforcer of SGP rules, which would assure the viability of the euro. Even when deficit levels diverged between countries before the sovereign debt crisis, bond yields demonstrated little movement away from the Eurozone average. The deficit and debt levels were effectively not enforced in any significant way in the financial markets, allowing countries such as Greece to borrow at substantially much lower rates than they otherwise would have been able to.

Market responses to changes in deficit and debt levels after 2008 were much more pronounced as shown, and many of the changes in bond yields were disproportionate to the relative changes in debt levels. In other words, markets treated the effectiveness of the SGP differently before and after the beginning of the sovereign debt crisis. Interest rates for Greece, Portugal, Italy, and Ireland increased substantially with the sovereign debt crisis. Rapidly rising

borrowing costs have in all likelihood made meeting the SGP thresholds even more difficult, as seen with the remarkable increases in debt for Ireland and Greece since the sovereign debt crisis.

In fact, Eurozone countries faced less market discipline than those outside the Eurozone (see Eichengreen (2005)). While arguably beneficial to provide more flexibility during economic cycles, the lack of much market difference undermined the effectiveness of the targets, and when an economic recession hit, the countries had little room for maneuver to prevent falling into excessive deficit and debt levels.

## **2. 6 Lasting reform to the SGP?**

As the sovereign debt crisis heightened after 2009 and bond yields rose to substantial levels for several countries that were considered to have poor finances, European leaders sought to reassure the financial markets of their determination to maintain sound finances in the future and of their commitment to the continuity of the single currency. Given the limitations of the existing SGP, the EU attempted to reinforce it by launching the “Six-Pack”, which is a legislative package of six legal acts (five regulations and one directive) that entered into force on December 13, 2011.

On March 2, 2012, 25 EU countries agreed on an intergovernmental treaty, titled the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, commonly referred to as the Fiscal Compact or the Fiscal Stability Treaty. When ratified, the Treaty would enshrine budget and debt limits into their respective constitutions, with legally enforceable penalties for violators.

The euro had symbolized a new stage in European integration and the monetary union was to be the demonstration of the success of EU cooperation. However, it has not been effective. In order to move forward, something more is required. This is why as the crisis progressed

political leaders talked more and more about political, fiscal and banking union. The problem is that these changes are vastly more complex and difficult to implement than something like the ESM. They will take years to take effect. In the meantime, the euro is at risk of breakup on account of a run on the debts or banks of certain Eurozone countries.

### **3. Default and Temporary Exit**

Since late 2009, in addition to the worldwide economic recession, the Eurozone was hit with sovereign debt crises, particularly in peripheral countries that are considered to have weaker public finances. One of the countries most seriously hit is Greece. The country has not been growing since the onset of a deep recession. It has an extremely high unemployment rate of around 25% with youth unemployment over 50%, large government deficits, and large spreads between its borrowing rates and those of stronger Eurozone countries such as Germany and France.

As financial markets began to lose confidence in the sustainability of Greek public debt levels with the global financial crisis, government bond yields climbed, exacerbating the effects of high deficit and debt on Greece. With the country expecting that it would be unable to pay off debt payments fully, it has requested and received two rescue packages from the EU and the IMF, with the condition that the country make significant structural reforms and expenditure cuts. To this end, the Greek government launched five rounds of austerity measures, including large cuts in expenditure in the public sector, introduction of new taxes, increases in the rates of existing taxes, and sale of state assets. The introduction of austerity measures has sparked widespread protests while the Greek economy continues to shrink, necessitating new rounds of austerity measures to meet its fiscal targets. The ESM should come into force by the end of 2012 to

replace the temporary EFSF to provide rescue funds to countries in economic difficulty such as Greece. Greek economic growth continues to be lower than expectations, which means that the country will need additional rescue packages or have bondholders suffer further losses on their investments.

Austerity measures and internal devaluations have rarely been successful and have serious consequences for economic growth and employment, particularly for the youth. Greece's negotiation of Private Sector Involvement in March 2012 and the declaration of a "credit event" revealed that the markets had expected restructuring and the debt swap ended up being uneventful.

There are serious long-term implications of austerity measures. On the current trajectory, Greece will be forced to go to about 180% or more of its GDP in debt, up from the 2011 level of 160%. This is not a viable path because its net interest burden of 6.8% of GDP, the highest in the Eurozone, would climb to 7% to 10% of GDP. This is not possible particularly given Greece's track record in terms of deficits.

The EU continues to insist that there be no exit from the Eurozone for any country. A major issue with the single currency is that Eurozone countries do not have the political solidarity for joint fiscal policy and to allow large transfers from wealthier economies such as Germany to weaker economies like Greece.

The Fiscal Compact Treaty, which is expected to come into force by 2013, would impose financial sanctions on countries that breach fiscal deficit and debt reference values. However, it would have limited impact in Greece where a recessionary economy makes it difficult to keep deficits under the permitted value.

Going forward, the Eurozone, especially Greece, will need to find a lasting solution to the sovereign debt crisis and find a path for growth for the country. Greece enjoyed high growth before the crisis and will need a way out of deep recession. Given the severity of the crisis and the lack of viable alternatives, default and competitive devaluation need to be a part of the consideration set before the situation in Greece further worsens.

A quick default and temporary exit from the euro and devaluation of Greece's currency is a possible and practical solution to the crisis. Once Greece recovers and satisfies the criteria for adopting the euro ("Maastricht criteria"), it can go through the process of re-joining the Eurozone when it is in the position to do so. The financial markets would be incentivized to monitor and enforce discipline on Greek's public finances with Greek debt spreads, which the markets did to a much lesser extent prior to the sovereign debt crisis. It can be a viable option, as opposed to the current system of political enforcement.

### **3.2 The Greek economy since the Euro**

In the 1950s to the 1970s, Greece was one of the fastest growing economies in the world, enjoying growth at about 7% of GDP. In recent decades, economic growth has slowed and labor costs in Greece continued to climb, whereas other European countries, notably Germany, took on reforms to increase their competitiveness.

After its entry to the Eurozone, Greece benefited from much lower borrowing rates to increase government expenditure and run large structural deficits. Even before adopting the single currency, the country had high debt and deficit levels and the situation did not improve in the decade since entry into the Eurozone, where they reached well over the limits prescribed by EU legislation. Debt remained at around 100% of GDP from 1995 on and began to climb once the global financial crisis hit. After the onset of the crisis, the country was thrown into a deep

recession and economic indicators, including unemployment, current account trade balance, industrial production and real effective exchange rate, show a deteriorating economy that has been seriously impacted by the recession and the sovereign debt crisis.

In 2011, Greek GDP fell by 6.9%, with real GDP falling below 2005 levels or about 13% since 2007. The decline in real GDP was well above IMF projections, and thus the path to economic recovery would take more time. The IMF had to adjust its projections for GDP several times since its First Review, totaling 6.9% in 2010 (Weisbrot & Montecino, 2012). A vast variety of other figures suggest a sharp contraction in demand, including retail trade volume, manufacturing PMI, industrial orders, and bookings in the tourism industry. Industrial production fell 8.3%<sup>2</sup> in 2011 alone to pre-1993 levels.

The unemployment rate more than doubled from about 10% in 2006 to 23.1% in May 2012 and an alarming 54.9% for those under 25. The Greek economy is expected to continue shrinking in 2012.

Unit labor costs are high, compared to the rest of the Eurozone. Whereas unit labor costs were about 60% that of Germany in 1995, they surpassed German unit labor costs in 2010. The real effective exchange rate also shows that the currency is overvalued for Greece compared to Germany, making the country's exports uncompetitive on the international markets. Despite the introduction of measures for labor market reform, including large cuts in minimum wage, the real effective exchange rate has not even fallen to 2006 levels. Without its own independent monetary policy, it would be rather difficult for Greece to continue to rely on these structural reform measures to bring about internal devaluation to bring its costs in line with competitive European economies.

---

<sup>2</sup> Economic and Financial Data for Greece, <http://www3.mnec.gr/sdds/users.asp>. See also IMF (2011, 2012).

Greece has the highest current account deficit in the Eurozone, at about 10% of GDP, well above projections by the IMF. Since Greece has a lower than average share of exports in output compared to other European countries, improvements in competitiveness have not contributed as much to improving the current account balance as hoped. Given the country's participation in the euro, it does not face the same import compression associated with a crisis as do other countries.

According to the IMF (2011, 2012), with the imposition of austerity measures, competitive gains have not been evident, with the deflator-based real exchange rate showing no improvement since 2009. Due to higher-than-anticipated inflation and rigidities in the labor and product markets, unit labor costs fell and total productivity increased only in 2011, and this improvement comes as unemployment continues to rise rapidly.

The austerity measures have the consequence of being procyclical, even though they brought deficit before interest payments down from €24.7bn (10.6% of GDP) in 2009 to just €5.2bn (2.4% of GDP) in 2011.<sup>3</sup> Revenues from privatization have also fallen well under projections by the IMF, which could mean a much higher debt-to-GDP ratio than previously forecasted. These measures and the recession, with the effects of high unemployment, fall in income and rise in poverty rates, have serious social and economic implications for the country in the short term and in the long term.

Despite multiple rounds of rescue packages and a debt restructuring, Greece still has the highest net interest burden in the Eurozone as well as high borrowing costs from the financial market. Interest payment made up 6.8% of Greece's GDP in 2011 and could cost the country 7-10% of GDP if the current situation continues. This is a significant strain on the Greek economy and is unsustainable for economic growth.

---

<sup>3</sup>Smith, H. (2012, February 2). Ease up on Greece, says IMF mission boss. *The Guardian*.

### 3.3 The Case of Argentina

From 1999-2002, Argentina suffered a severe economic crisis that was partly caused by a currency board arrangement fixing the Argentinian peso to the US dollar, large fiscal and trade deficits in the previous decade, and substantial increase in debt levels. Argentina was hit with one of the worst decreases in total output, with a decrease of 10.89% in GDP in 2002.

The case of Argentina's financial downturn and its subsequent decision to default and devalue can serve as an interesting parallel with the case of Greece and the sovereign debt crisis. Argentina was directed by the IMF to introduce an austerity plan, not unlike that of Greece, to make large cuts in government spending, increase taxes, and push for more labor market flexibility with structural reforms. The hope was that Argentina would internally devalue and make itself more competitive, while maintaining its debt payments and the currency board.<sup>4</sup>

As the recession continued, the unemployment rate rose to 25% and opposition to austerity measures became widespread. In a report on Greece's progress, the IMF admits that the Argentine economy was "trapped in a downward spiral in which adjustment through internal devaluation eventually proves impossible". It further argues that the way Argentina was able to get out of the crisis was "default and the abandoning of the exchange rate peg".

With fears from international investors that Argentina would default on its debt, the government cut spending and raised taxes, which were procyclical measures that furthered decline in GDP and necessitated additional austerity measures to meet targets.

Measures for internal devaluation lasted about three and a half years before the country defaulted and ended the convertibility for the peso in January 2002. During that time, the country experienced a 20% decrease in output and a huge increase in debt, large cuts in wages and

---

<sup>4</sup> Navarro-Staicos, J. (2012, April 2). Greece should follow Argentina into default and devaluation. *The Christian Science Monitor*.

pensions, widespread unemployment and bankruptcies, as well as a collapse of the banking system.

The country has made a remarkable recovery since 2002, returning to growth only a quarter after its default, and achieving high rates of growth until the global financial crisis. With growth averaging 8.5% of GDP per year, the fastest in the Western hemisphere, it took only three years for Argentina to resume output to its pre-crisis level and for its GDP to double by 2011 as shown in Figure 4.

Argentina's success is commonly attributed to a commodities boom and proximity to the neighboring booming Brazilian economy. However, Frenkel and Rapetti (2008) argue that a substantial source of growth was import compression and increased domestic consumption and investment, made possible only by relieving the country of a heavy debt burden. Without the need to implement austerity plans, the Argentine government was able to implement a macroeconomic policy that focused on employment and growth, as well as aiming for and maintaining a reasonable effective exchange rate target. A more favorable exchange rate then allowed Argentina's agricultural export sector to expand and benefit from a significant price boom. Cohen (2012) argues that the recovery was a "demand-led recovery" that was supported by increased demand for domestic production of goods and services, since import prices had gone up considerably after devaluation. Damill, Frenkel & Maurizio (2006) confirm this finding, and add that employment was improved partly by a successful unemployment subsidy program, an increase in nominal wages, and an overall higher labor intensity in output. Rather than being "lucky", Argentina was able to take advantage of the inherent strengths in its economy such as an educated labor force and developed infrastructure to return to economic growth.

Argentina during its economic crisis has several similarities with Greece in 2012.

Argentina pegged the peso to the dollar in 1990 to control hyperinflation, which was successful but restricted the ability of the government to control money supply. On the other hand, Greece joined the euro, fixing its exchange rate with that of other Eurozone countries. Like Argentina, the country suffers from an overvalued currency, making its goods uncompetitive both in Europe and on the global markets. Both countries benefited from increased capital flows, which halted with the arrival of global financial crises. Because of its large deficit and debt levels, Greece's borrowing cost is high, making its fiscal situation unsustainable. Despite mandated austerity measures and rescue packages from the IMF to service the country's debt, the economy continues to shrink and unemployment rises.

Argentina was able to get out of the spiral by abandoning procyclical policies and exiting a currency arrangement to restore its competitiveness on global markets. If Greece were to default and leave the euro temporarily, it would have the chance to start growing again and to bring down unemployment. Under current policies the recession is likely to continue and it will be a substantial time before unemployment is reduced significantly.

### **3.4 Other Cases of Competitive Devaluations**

Currency devaluations in the 1930s were often criticized as “beggar-thy-neighbor” policies that made exchange rates unpredictable and disrupted international trade. However, Eichengreen and Sachs (1985) argue that the Gold Standard in the late nineteenth and early twentieth centuries led to overvalued currencies, and the countries suffered from the overvaluation during the Great Depression. In their study, they find that countries leaving the gold standard in the 1930s saw faster recovery of their economies, which demonstrated the efficacy of exchange rates in promoting growth. Industrial production recovered more quickly,

and real wages tended to be lower and export volume higher. To this end, exchange rate change can be seen as a factor in affecting economic recovery and a country's competitiveness.

The study found that depreciation benefited the countries that depreciated first. While the effect of individual devaluations was negative for other countries, there was some mutual benefit from competitive devaluations taken in a group of countries. Thus, there is no presumption depreciations were beggar-thy-neighbor.

In fact, it was perhaps the sporadicness or lack of implementation of worldwide devaluation that reduced the benefits of devaluation and led to negative effects on other countries. These countries would have grown much more quickly and recovered from the Great Depression, had these policies been coordinated internationally and more widely adopted. Repercussions could have been worse in the absence of such devaluations. Devaluations were able to help countries recover quickly because it corrected the basic problem of incorrect relative prices.

An interesting comparison on the effectiveness of exchange rate adjustment is between South Korea and Japan from 2007-2011 as shown in Figures 5 and 6. The two countries have similar industrial structures so should have been similarly affected, other things equal, but Japan is viewed as a "safe haven" so its exchange rate did not adjust and its growth performance was much worse.

The Korean won depreciated from 938.20 won/dollar in 2007 to a peak of 1573.60 won/dollar in 2008. Yoon (2011) shows that a highly depreciated currency was beneficial for the country to increase its exports and depress domestic demand for imports. Korean exporters were able to benefit from global stimulus packages, including the 4 trillion yuan stimulus package in China. Korea began recording a trade surplus, which brought foreign liquidity into the Korean market.

Another important example is Finland in the early 1990s, where the country was hit by the collapse of the Soviet Union and a crisis in Sweden. After the 1989 revaluation of the Finnish markka, industrial output began to contract, which fell by 9% in 1991, due to a stop in exports to the Soviet Union and a global economic crisis. The country suffered from a collapse in domestic investments and consumption.

The markka was devalued in November 1991, which resulted in a quick recovery in exports and industrial activity. Exports grew rapidly and became a large contributor to GDP growth, and by 1997, exports amounted to 40% of GDP.<sup>5</sup>

#### **4. Possible Greek Default and Exit from the Eurozone**

Greece faces an enormous burden of austerity measures in the midst of a shrinking economy and extremely high unemployment, and would eventually face pressures to repay EU and IMF funds. Given the substantial social, economic, and human cost from implementing structural reforms for internal devaluation and the procyclicality of these reforms in dampening Greece's prospects for economic growth, we believe Greece should default and take a temporary exit from the euro. The external devaluation that this would allow would permit Greece to get out of the crisis and for the Greek economy to grow again.

Under this scenario, Greece would make a quick exit from the euro and convert the denomination of all debts that are governed by local law on a one-to-one basis from the euro to the drachma, Greece's provisional new national currency. The arrangement would affect most of the Greek sovereign debt and presumably most of the private debts. The new currency would be set to float and adjust to its market level, for example, two drachmas to one euro. Greece would become more competitive quite quickly and start growing. However, it would lose access to

---

<sup>5</sup> Statistics Finland, [http://www.stat.fi/tup/suomi90/toukokuu\\_en.html](http://www.stat.fi/tup/suomi90/toukokuu_en.html)

capital markets for some time, but this may not be as long as some expect. Greece would receive a boost from not having to service half to two-thirds of their debt, both sovereign and private. The country would then be able to pursue growth-led strategies that help it climb out of the deep recession. Once Greece achieves low deficit and debt levels and satisfies the Maastricht convergence criteria for adopting the euro, the country could rejoin the euro at a more favorable exchange rate.

The current solutions imposed on Greece are having a limited effect. Austerity measures would have to continue to be implemented despite widespread protests. Growth has been much slower than expected, and given the dire economic circumstances, IMF's target for Greece to regain access to markets looks difficult to achieve in the short run. Fiscal adjustments are not having the effect of restoring solvency to the country and investor confidence, which have the result of pushing borrowing costs even higher.

The IMF admits that internal devaluations are difficult to achieve and rarely successful, due to large fiscal imbalances and foreign debt. Recessionary pressures are aggravated when pursuing procyclical fiscal policies to restore competitiveness through internal devaluation. Important factors cited by the IMF for successful devaluations include high wage and price flexibility, factor mobility, close economic integration with the currency area, high public support for maintaining currency regime and strong credibility of its fiscal adjustment programs.

In its assessment of internal devaluation for Greece, the IMF (2012) notes:

“[...] the country's initial conditions look unfavorable in comparison with prior international experience. Most of the conditions for success are missing in Greece. At the onset of the crisis, Greece combined double-digit fiscal and current account deficits; a high level of public debt; a highly negative international investment position; a small export base; deeply ingrained structural rigidities in labor, product, and service markets; and a tense and unstable political and social setting. This suggests that political resolve and bold front-loaded reform implementation are absolutely critical for internal devaluation to work in

Greece, and that continued large-scale official support will be needed to alleviate the painful adjustment process.” (p. 49).

There is a need to recognize the lack of effectiveness of internal devaluation measures and to identify alternative solutions. Greek debt levels are currently unsustainable. Large, outright fiscal transfers from Northern, highly rated countries such as Germany, the Netherlands and Luxembourg to write off Greek debt are impractical politically. An orderly default, as well as a temporary exit from the euro, is a solution that could avoid prolonging the recession and putting additional pressure on other EU countries. Greece has already partially defaulted on some of its debt through the Private Sector Involvement arrangement in March 2012. This provides a good example of how default can occur to help Greece’s situation, but arrangement alone was too late and insufficient. By maintaining the euro, Greece continues to have high interest rates that not only makes it difficult to service its high debt levels, but would also have a detrimental effect on demand, overall savings, and consequently the overall economy.

Investors understand that only growth could get a country like Greece out of the debt trap, which is unlikely with reductions in government expenditures or increases in taxes. Since deflation is not occurring either, Greece needs a way to grow and regain competitiveness. An outright exchange rate devaluation, which would be an exit from the euro for Greece, can hasten economic recovery.

The largest trading partners for Greece are European countries, and devaluation would immediately restore competitiveness to its tourism, shipping, and manufacturing industries by making them much cheaper to the European market.

As the Argentinian case shows, external devaluation can be a chaotic and difficult process, but can possibly provide a path to increased competitiveness and economic growth.

## 5. Conclusion

Previous attempts to control countries' fiscal policies and debt levels through treaties have not worked. Current austerity policies implemented in Greece are very costly in terms of growth and unemployment, particularly among youths. Attempts to reduce deficits and the maintenance of the euro as a currency exacerbate recessionary pressures on the economy.

Sovereign default and a temporary exit from the euro could provide shock absorbers for countries and have the potential to be more efficient than current policies. The resulting competitive devaluation would restore relative prices and allow Greece to be more competitive on the global markets.

Argentina was able to take advantage of its default and external devaluation to pursue economic growth. The country has enjoyed high growth rates and recovered to its pre-crisis level of output in only three years. Other similar examples, the abandoning of the gold standard in the 1930s, as well as devaluations in Finland and Korea, suggest that an exchange rate adjustment could be a viable solution to help countries climb out of their debt and growth problems.

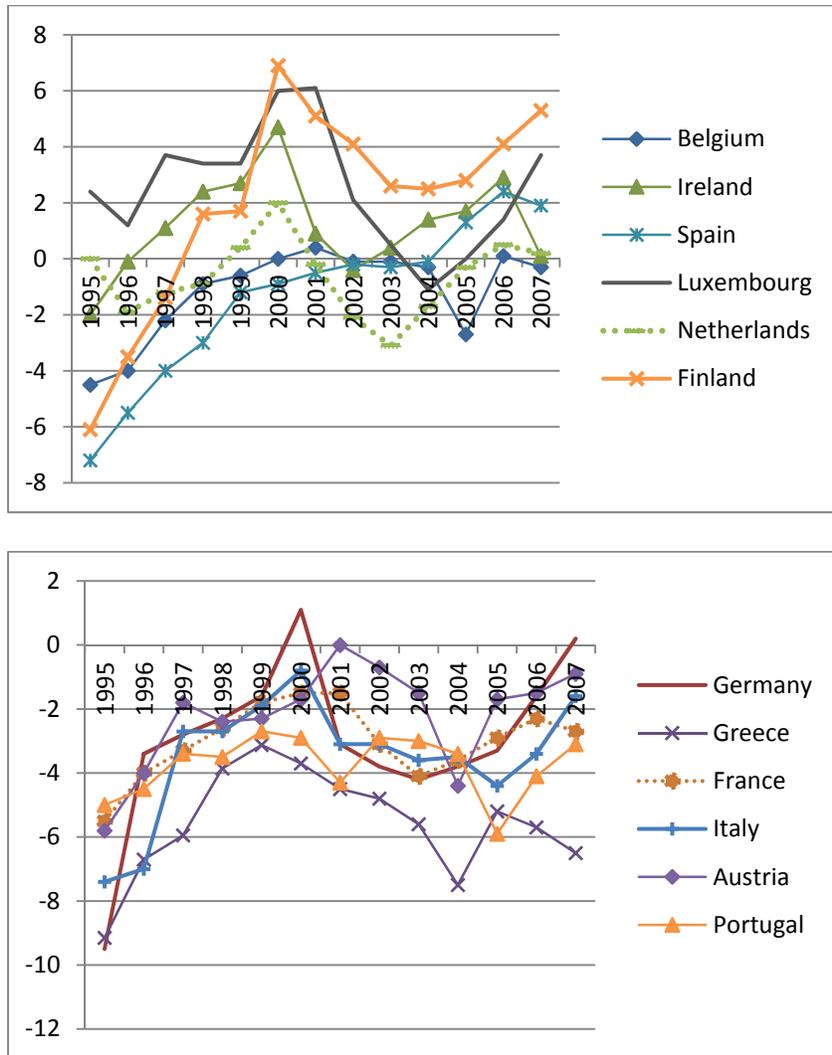
We have focused on Greece since its economy is in by far the worst shape of any of the economies in the Eurozone. However, if the Spanish and Italian economies follow a similar trajectory as a result of austerity measures, the opportunity to default and exit temporarily may be a good solution to their problems too. When Greece and possibly other countries leave as well, the Eurozone will finally be stable. This will allow it to survive into the long run as the institutions necessary for political, fiscal and banking union are developed over a period of many years. This will allow the euro to be a permanent feature of the European Union.

## References

- Cohen, M. A. (2012). *Argentina's economic growth and recovery: the economy in a time of default*. London; New York: Routledge.
- Damill, M., Frenkel, R. & Maurizio, R. (2006). *Macroeconomic policy changes in Argentina at the turn of the century*. International Institute for Labour Studies.
- Eichengreen, B.J. (2005). Europe, the euro and the ECB: Monetary success, fiscal failure. *Journal of Policy Modeling*, 27(4), 427-439.
- Eichengreen, B., & Sachs, J. (1985). Exchange Rates and Economic Recovery in the 1930s. *Journal of Economic History*, 45(4), 925.
- Frenkel, R., & Rapetti, M. (2008). Five years of competitive and stable real exchange rate in Argentina, 2002-2007. *International Review of Applied Economics*, 22(2), 215-226.
- International Monetary Fund. (2011). *Greece: Fifth Review Under the Stand-By Arrangement, Rephasing and Request for Waivers of Nonobservance of Performance Criteria*. IMF Country Report No. 11/351.
- . (2012). *Greece: Request for Extended Arrangement Under the Extended Fund Facility—Staff Report*. IMF Country Report No. 12/57.
- Ngai, V. (2012a). “Stability and Growth Pact and Fiscal Discipline in the Eurozone.” Wharton Financial Institutions Center Working Paper 12-10, University of Pennsylvania.
- . (2012b). “Introduction to the Stability and Growth Pact.” In F. Allen, E. Carletti, and S. Simonelli (Eds.), *Governance for the Eurozone: Integration or Disintegration?* (pp. 213-227) . Philadelphia: FIC Press.
- Weisbrot, M. & Montecino, J.A. (2012). *More Pain, No Gain for Greece: Is the Euro Worth the Costs of Pro-Cyclical Fiscal Policy and Internal Devaluation?*. Center for Economic and Policy Research (CEPR).
- Yoon, Deok Ryong. (2011). The Korean Economic Adjustment to the World Financial Crisis. *Asian Papers* 10(1), 106-127.

Figure 1

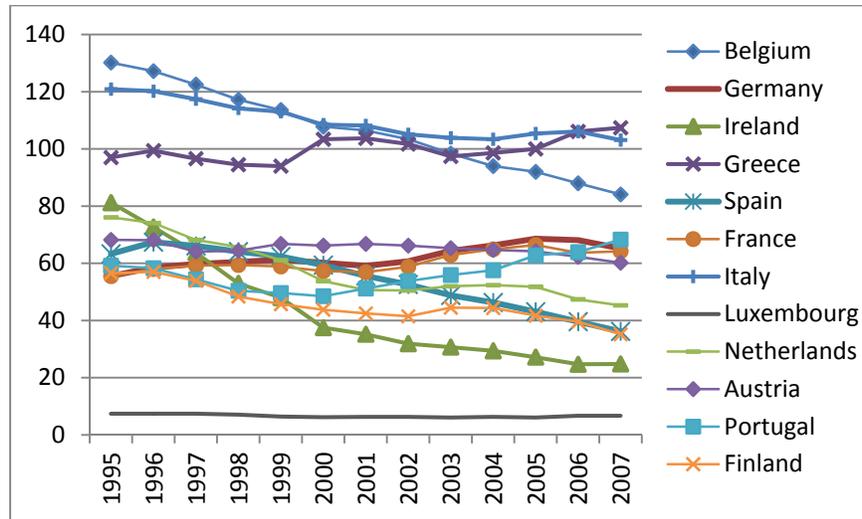
Eurozone government surplus/deficit as percentage of GDP (1995-2007)



Source: Eurostat

Figure 2

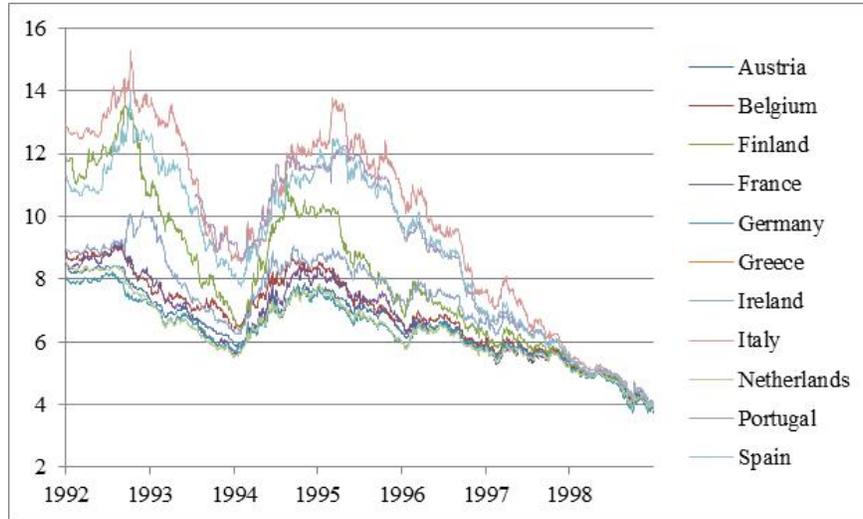
Eurozone government gross debt as percentage of GDP (1995-2007)



Source: Eurostat

**Figure 3.1**

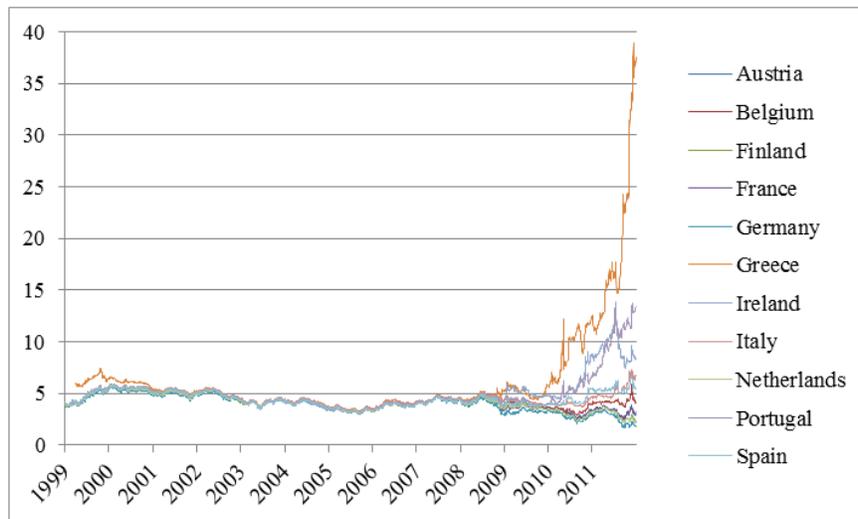
**Ten-year Government Bond Yields for EU-12 (1992-1999)**



Source: Thomson Reuters Datastream

**Figure 3.2**

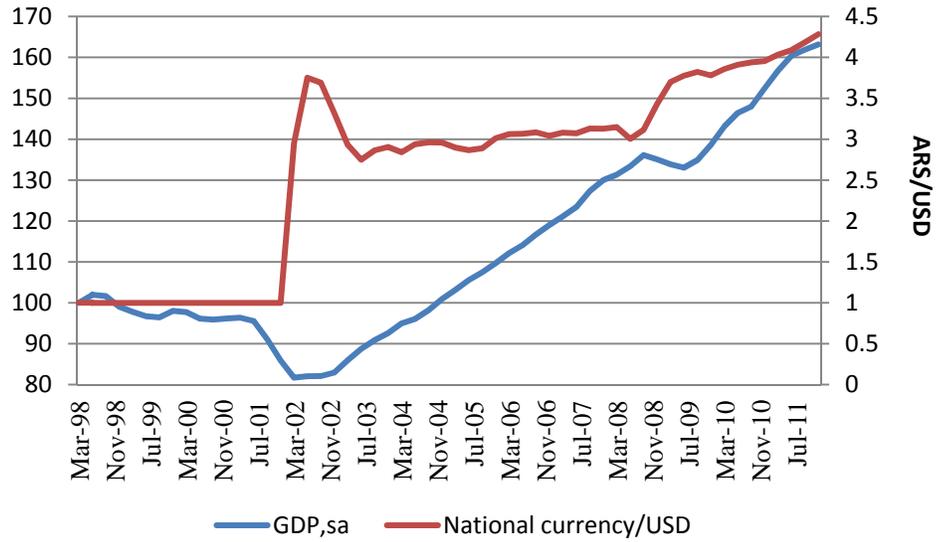
**Ten-year Government Bond Yields for EU-12 (1999-2011)**



Source: Thomson Reuters Datastream

Figure 4

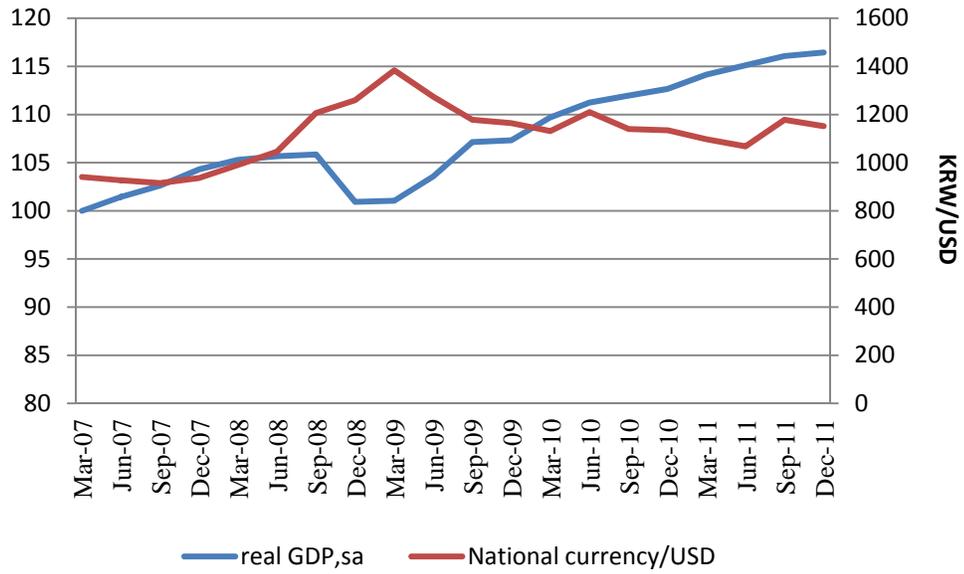
Argentina's Normalized Real GDP (1993 base year) and Peso-Dollar Exchange Rate, 1998-2011



Source: International Monetary Fund; Instituto Nacional de Estadística y Censos de la República Argentina

Figure 5

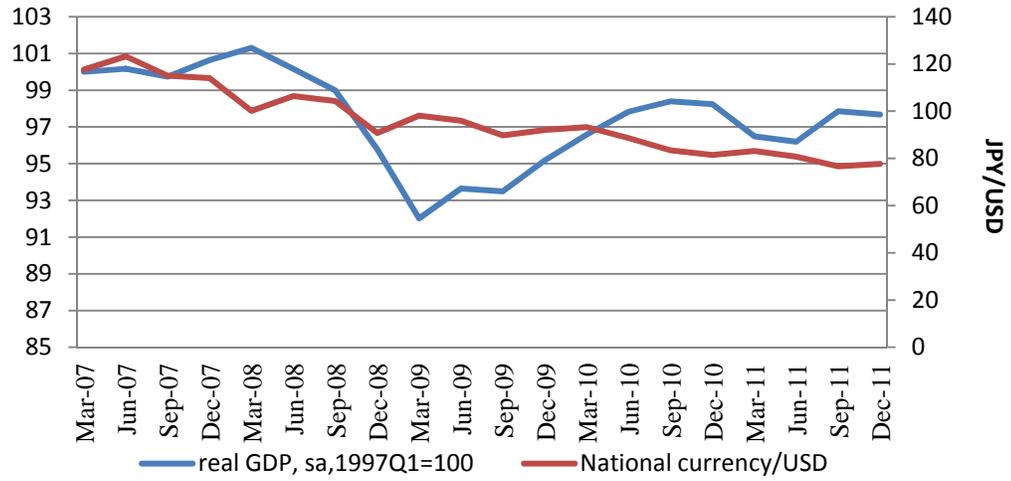
Korea Real GDP (2005 base year) and Won-Dollar Exchange Rate, 2007-2011



Source: International Monetary Fund; Bank of Korea

**Figure 6**

**Japan Real GDP (1997 base year) and Yen-Dollar Exchange Rate, 2007-2011**



Source: International Monetary Fund; Economic and Social Research Institute (Cabinet Office of the Government of Japan)