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THE GREEK DEBT CRISIS AND ITS IMPACT ON EUROZONE SOVEREIGN DEBT

Brian Berzin

Introduction

With the inclusion of Greece in 2001, the Eurozone had grown to twelve member countries, all of which had accepted a uniform monetary policy that was not consistently beneficial to all members. Individual currencies allow modern countries to lend with country-specific exchange and interest rates. Exchange rates and interest rates fluctuate with economic success and failure. Under the euro, countries no longer experience this natural symbiosis, and instead have a single monetary policy regulated by the conditions of the largest economy in the union, which most frequently has been Germany. Simultaneously with German prosperity, the economies of most European countries were crumbling and falsifying accounting records to hide the dire situations that became commonplace.

In Greece, the sovereign debt crisis stemmed from historical social and political problems, many of which originate in the Greek culture. Over the past 200 years, Greek social norms have come to include federal tax fraud, abuse of the pension system, and a reliance on a socialist public sector, all of which were masked by deceptive accounting practices. German, French, and domestic Greek banks were significant lenders to Greece, enabling its debt crisis. The situation was not unique to Greece, either, as German and French banks were also significant lenders to Italy, Spain, and Portugal. As Greek bonds lost investor confidence from 2009 to 2011, doubt began to spread to the other weak Eurozone economies and in turn to lending financial institutions. The creation of a currency union without a core fiscal union had formed an economic abscess in the roots of an innovative, regional financial authority. Now, the financial decisions and interactions among the lead Eurozone economies will have enduring consequences on world economies and financial markets.
A History of Greek Default

Beginning with its independence in the 1820s, Greece has been habitually in default or cut off from external capital markets. Greece’s reputation in global capital markets has been built on a long and distressed history, which often resulted in higher borrowing rates to compensate for the increased risk of default.

Historical yields on ten-year Greek bonds show that rates have been influenced by increased risk premiums as well as significant global economic events, including recessions, sovereign credit crises in other countries, and, most significantly, the acceptance of Greece into the EU. Risk premiums, or increased rates required by investors, adjust for increased likelihood of default. Risk premiums compensate for the occasional default of a debtor, covering losses with the increased returns on debt issues. The risk of default for highly rated countries is minimal. If a country’s probability of default increases, its credit rating falls and its risk premium rises. An extremely low “junk” credit rating signals a near-default scenario and has a very high implied yield to compensate for the increased default risk. When Greece entered the EU, however, its risk premium fell, in part due to the falsified historical debt levels used to gain admittance. Greece’s status as a new EU member also lulled global creditors into a false sense of Greek economic security and stability.

European Union Membership & Early Evidence of a Sovereign Debt Crisis

The EU’s 1993 Maastricht Treaty established specific requirements for EU countries adopting the euro. The treaty established rigorous economic ratio benchmarks including inflation, annual deficit and debt ratios, and interest rates. Thereafter, a single document would uniformly regulate economies across the EU. Individual countries within the EU, however, are not all the same: The massive German economy, based on strong exports, cannot be compared to Greece, which has an economy based on tourism and a shipping industry that pays no tax revenue into the Greek economy. Even before Greece’s induction to the Eurozone in 2001, problems were already brewing, both inside the existing EU and within the Greek government.

In “The Euro-Descent into Hell,” German economist Wilhelm Nölling described the follies of a single currency union used by many different nations, each with its own fiscal policy. Different countries had different motives for joining the economic venture. Germany, for instance, saw a huge trade opportunity. With the creation of a single European currency, Germany consistently grew its economy from the amplified trade and uniform currency, and its GDP increased steadily. The increased German exports also meant that Germany was in essence exporting unemployment to many other parts of the EU. In many countries, German imports infringed significantly on what had previously been domestic spending. Other, smaller countries, such as Greece, gained tremendous opportunities to obtain cheaper capital, as well as increased tourism, from the euro area. As a result of entrance into the Eurozone, many countries saw new opportunities for foreign direct investments.

Although the reasoning for countries entering the EU varied, many countries faced similar hurdles to meet Maastricht Treaty requirements. The various treaties and agreements that hold the EU together, however, are vague regarding accounting standards and transactions that fall under regulated debt levels. Financial reporting of deficit levels for Spain, Greece, and Portugal were crafted to meet EU standards where necessary, without accurately accounting for the real levels of debt and budget deficits. This common practice, though apparent from the beginning, had not impacted sovereign borrowing until mid-2000.

In 1996, an EU summit discussed fines for not adhering to the EU economic conditions, which included a set of legal penalties dubbed as “a paper tiger” by Willem Buiter, former chief economist at Citigroup (Forelle and Fidler). The actual rules, regulations, and policies were ineffective at regulating EU countries. Although the infamous “Greek Sovereign Debt Crisis” gained global notoriety just in 2009, a long paper trail was evident as early as 2001 to observant investors. As Michael Lewis observes in his book Boomerang: Travels in the New Third World, the few people who realized the start of the global financial crisis and understood its causes could
profit through taking positions, instead of helping solve the issues (p. 20).

In 2001, over $19 billion was lent to Greece through currency swap derivatives arranged by U.S. investment bank Goldman Sachs (Dunbar and Martinuzzi). Due to the swap listing as a derivative, Greece was able to keep the debt “off the books” legally, which did not impact EU regulation thresholds. One such deal, called “Aeolos,” supplied Greece with funding in exchange for annuities of payments by publicly owned airports, and other derived cash flows, until 2019 (Story et al.). Although Goldman Sachs and Greece did not receive widespread public criticism for such deals until the debt levels were unsustainable, a 2003 article in Risk magazine identified the derivative situation, which was also fully disclosed in the Greek Parliament (Martinuzzi). In a broader context, the $15 billion transaction, a completely legal and common operation, accounts for only a fraction of a percent of Greece’s total debt, but both Goldman Sachs and Greece were ultimately scorned. This transaction was one of many that slowly accumulated, veiled from traditional debt records. By 2005, even Goldman Sachs viewed the interest rate swap with Greece as too risky and, to avoid future exposure, Goldman Sachs sold the remaining cash flow streams to the National Bank of Greece at a discount (Story et al.).

Changes in accounting standards occasionally uncovered some of the debt loopholes frequently exploited by Greece as it prepared to enter the EU. Eurostat, the EU’s statistical information division, revised Greece’s historical deficit levels in 2000 as Greece began talks to enter the Eurozone. The new standards increased the 1998 deficit from 2.5 percent to 3.2 percent (Forelle and Fidler). Three years later, in 2004, the 1998 deficit levels were revised, yet again, to include other buried sovereign debt transactions of an additional $2.4 billion, to 4.3 percent. In retrospect, signs of the Greek sovereign debt meltdown were readily discernable well before the country entered the Eurozone. Similarly, the 2003 deficit levels, as well as many other annual levels, were steadily being revised by Eurostat, all the way to 5.7 percent in 2005.

During the rule of PASOK (Greece’s socialist party, which ruled in much of the 1980s and 1990s), Eurostat revised Greek budgets from the previously reported surpluses to extensive deficits. When Eurozone membership was granted under the PASOK regime, it was not yet obvious that the administration had misrepresented the targeted economic benchmarks to strengthen its case for acceptance. When PASOK lost the 2004 election to Prime Minister Kostas Karamanlis of the conservative New Democracy Party, public debt levels were already at an estimated 103 percent of GDP and growing (“Timeline . . .”). Under Karamanlis, debt levels were internally revised yet again to more realistic levels, but debt such as the Goldman Sachs transactions was still maintained off the books as it was not considered sovereign debt by the EU’s accounting standards. Greece fabricated economic data every year as well, and exploited accounting EU standards. National defense and healthcare spending were almost always misstated, and Eurostat revised Greek statistics time and time again to reflect the true amounts (Balzli). Billions in pension financing from sovereign debt sources were unaccounted for in Greek debt levels (Lewis, p. 47).

The shady government transactions were not unique to any one political regime; all parties shared some degree of guilt. Under Prime Minister Karamanlis and the New Democracy Party, debt continued to grow unregulated, and lenders continued to offer low interest rates. In 2009, the New Democracy Party was voted out of power, and back came PASOK, a party that had contributed its share to the damaging accumulation of sovereign debt. Shortly after the elections, debt levels were suddenly and drastically revised from a Eurozone-compliant 3 percent to a deficit higher than 12 percent. By April 2010, Greece had to appeal to the International Monetary Fund (IMF) for emergency funding to avoid default (Strupczewski).

Many countries throughout the EU were in similar sovereign debt situations, although the spotlight was not yet on them. Visible evidence of corruption and unsustainable debts was overlooked, as were histories of default. Creditors nonetheless continued to lend money irresponsibly to Greece and other fiscally weak EU countries, even without risk-adjusted rates of return. These lenders eventually felt the negative impact, as credit was extended without the
added compensation from adequate risk premiums. Historical precedents for default no longer were incorporated into the risk premiums on sovereign debt issuances within the EU. Lenders saw the EU as a single, strong economy, instead of a collection of diverse economies. Greece could borrow at the same rates as Germany because lenders overlooked the risks involved.

European Trends in Government Debt

The lack of sovereign default by the 2000s was one of the largest oversights in the financial history of modern civilization. After a worldwide trend of normal defaults in the 1980s and '90s throughout South America and Europe, the suddenly calm seas in the EU were attributed to economic policy success. In reality, as seen very clearly in hindsight, Europe was just brewing a “hundred-year flood” of defaults (Rogoff and Reinhart, p. xxviii). As Germany continued efforts to unite Europe and maintain yearly trade surpluses from a connected euro economy, lending rates fell, and risk premiums were abandoned. Governments in Greece and Italy immediately took advantage of the low borrowing rates and increased the previously nonexistent long-term national debts to unsustainable levels. Creditors continued to lend, ignoring all signs of a brewing sovereign default crisis.

Benefiting from the cheap Eurozone capital markets access, socialism flourished in the less-developed southern European countries. The governments of Greece, Italy, and Spain dumped the borrowed funds into pension and unemployment funding, and promoted an unsustainably high standard of living and diminishing national incomes. Greece’s revenue from tourism and a reliance on “importing visitors” made up nearly one fifth of the entire Greek economy (Karabell), and shipping was not taxed.

The Second Great Contraction

As the first decade of the new millennium waned, global financial and economic markets entered unprecedented turmoil. The Second Great Contraction began in the banking industries of United States, Ireland, and Iceland. Although this contraction was different from the Eurozone sovereign debt calamity, economic uncertainty spread, and doubt was cast upon the stability of sovereign government debt and currencies.

German banks had participated in sub-prime lending to American borrowers (Lewis, p. 147), and had to write off $25 billion when the U.S. real estate market collapsed in 2007. As the housing market and attached mortgage-backed securities market fell, contagion spread throughout the U.S. banking sector. In his 2011 speech in Jackson Hole, Ben Bernanke cited the response of European leadership in arguing that political paralysis had become the primary obstruction to recovery (Rogoff, “Will The IMF . . .”). The U.S. government took quick action to address the growing predicament and contain the impact on the banking sector. To prevent a full-scale national banking crisis, the U.S. government inadvertently increased the risk of a debt crisis by resorting to deficit financing. A traditional post-collapse recession was expected, but quick implementation of reforms and bailouts provided some hope for a quick recovery.

The connections among the sovereign debt, banking, and currency crises are clearly evident throughout the Second Great Contraction. Historically, a mix of sovereign debt, fiscal stimulus, and monetary policy can strengthen a frail economy and promote growth. In the EU, however, the currency infusion prevented fiscal and monetary policy from being tailored to the specific needs of individual countries, and new burdens of contagion within the EU were cultivated. Germany also experienced repeatedly poor risk management in its lending practices and failed to identify risky investments that would ultimately lead to default. The results of German banks’ insufficient lending standards had already emerged in their losses during the financial crises in the United States, Ireland, and Iceland. The German origination and underwriting of sovereign debt to faltering countries within the EU (such as Greece) continued.

Due to banking meltdowns around the world, foreign lending to Greece and other EU countries diminished, and exports fell. Historically, as Rogoff and Reinhart observe in This Time is Different, “banking crises in advanced economies significantly drag down world
growth” (p. 73), especially for countries in the periphery. Refinancing the maturing debt of Greece and Italy became increasingly hard, and global capital markets quickly became more risk averse.

A Loss of Confidence in Greek Debt

When the newly-elected Greek government publicly announced the revised public debt level of 127 percent of GDP in 2009, Greek bond prices fell drastically and yields soared. The IMF immediately moved in to aid Greece in 2010, which was suddenly cut off from external capital markets (Stearns and van de Pol). The IMF bailouts, however, were merely short-term solutions that only delayed the inevitable Greek default on debt. In late 2011, waves of IMF funding would be awarded if certain government benchmarks, including budgetary cuts, were met. As Greece fell into economic contraction following the 2009 outbreak, the government was unable to make progress. It was reported that, without the $10.8 installment in September 2011 of the total $161 billion IMF loan, Greece would have fallen into default on its interest payments as early as mid-October of that year.

In Greece, the IMF bailouts were very unpopular. Greeks enjoyed their high quality of life and were so accustomed to deficit spending that it had become an integral part of their culture. Greek citizens did not realize fully how unsustainable their policies had become, and having foreigners tell them to cut back on the spending that supported their quality of life was not popular. Protests ensued, and both government rule and social norms failed to adapt. Even though Greece was projected to collect higher government tax revenues, restructuring the overburdened public sector was much more costly than originally anticipated by foreign and IMF authorities. Future policies will most likely continue to be unpopular as changes in the pension and tax systems need to increase revenues.

Foreign direct investment (FDI) continued to decline through 2011, and Greek GDP had diminished by 12 percent since 2008. By the third quarter of 2011, Greek bond prices indicated a near certainty of default. The 2011 deficit was continually revised throughout the year, eventually reaching 8.5 percent of GDP because the recession was deeper than expected. As each wave of bailout funding approached, market volatility grew in succession, thus enabling U.S. and European markets to regain traction each time funding was secured (Wagner and Levy). The volume of Greek bonds traded had also shrunk to very low levels. Similar to U.S. Federal Reserve debt, where primary dealers are required to make a market, banks were required to make a market for Greek debt. To compensate for this risk, three-year Greek debt traded at 172 percent yields, including a bid-offer spread (the difference between the price at which a dealer is willing to sell and the price at which a dealer is willing to buy) for bank involvement of 47 percent (Oakley). No one wanted to touch the flagging and illiquid Greek bond market even before talk of outright default began. In comparison, bond yields on Belize debt jumped to only 17.15 percent in 2006 as the country teetered on default, nowhere near the unprecedented Greek bond yields (Barden).

The IMF and European leaders were dragging out the Greek crisis much longer than any historical default scenario while they attended to the well-being of their own respective countries. By 2010, all global markets had been affected by the Greek crisis; even gold and silver hit record levels. In terms of market value, Greek debt became almost worthless in 2011. If European banks had marked their positions to market, similar to the way U.S. banks had done during the U.S. financial crisis, many financial institutions would have collapsed instantaneously (Rappaport). Instead of marking to market, European banks slowly purged their balance sheets of Greek sovereign debt.

Throughout the political contraventions and constant debate on policy, both bond yields and Credit Default Swaps (CDSs) accurately depicted a borderline 98 percent probability of default by September 2011 (Moses). Prices on Greek CDS rose to roughly 4,000 basis points (equal to 100 basis points per percentage point) (Oakley). On top of the high price, institutions

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A CDS is a derivative which allows investors to hedge against certain credit events (such as European sovereign default) without holding an underlying insurable interest. In default, the issuer covers some or all of the loss of the CDS purchaser, similar to the payoff of an insurance contract.
were required to pay 57 percent up front of the money insured against Greek sovereign debt. Further mitigating the risks of Greek default at this point in time was almost impossible.

Ownership of Greek Debt

Domestic credit continues to tighten around Greek banks. Similar to prior U.S. and Icelandic financial crises, deposits and faith in the banking system have sharply declined. Although not often mentioned in the media, Greek banks face dramatic capital risks due to the decline in deposits in addition to their large holdings of Greek sovereign debt.

Based on 2010 year-end financial data from the Bank for International Settlements (BIS), Greek banks held somewhere between $65 billion and $78 billion of government bonds (Groendahl). National Bank of Greece officials insisted that banking exposure to sovereign debt was minimal and Greek banks were not highly involved in the lending. According to the Bank of Greece's 2010 International Investment Position report, external liabilities of the government totaled $193 billion, with $50 billion also indebted to the IMF Bailout agreement (Bank of Greece . . .). Unable to write off debt without defaulting, publicly traded Greek banks held similar Greek sovereign levels at the end of 2011, which were also used to meet reserve requirements. Greek pension funds held almost $40 billion in sovereign debt.

Greek banks and pension funds are the largest owners of sovereign debt, with German and French banks and pension funds not far behind. In April 2010, Germany held $38 billion of sovereign debt, according to IMF data (Ewing). By the end of 2011, IMF figures showed that German ownership fell to somewhere between high and low estimates of $34 billion and $22.7 billion, respectively (Groendahl). At the end of 2011 it was noted that French banks also had significant holdings, with roughly $57 billion total (“Eurozone Crisis . . .”). Many banks were forced to reduce their exposures, often by writing off bad debt, and eventually through sales to the ECB, which held $65 billion in junk-grade Greek sovereign debt by 2012 (Groendahl).

In Q3 2011, BNP Paribas SA and Societe Generale SA wrote off over $3.1 billion when selling portions of their Greek sovereign debt in the face of record losses, credit downgrades, and tumbling stock prices. Although write offs and losses were being proactively absorbed on Greek debt, low investor confidence was evident in the stock markets. In January 2011, Standard and Poor's downgraded France from AAA to AA+ as debt contagion and market volatility had already spread throughout Europe to shake investor confidence (Weismann et al.). In the author's interviews with American investment bankers, a common lack of trust in French and German banking statistics was evident; U.S. bankers consistently pointed out “flaky” European bank accounting practices and flagrant fabrication of high ratios. If Greece were to default outright on its sovereign debt, French and German banks would be noticeably impacted, and quite possibly face collapse themselves.

A European Stalemate

The Greek economy was dependent on capital inflows from other EU counties. As cheap debt was no longer available or even rolled over, the IMF and ECB moved to bail Greece out. Historically, fiscal and monetary policy could be used to combat lack of funding, but due to the Eurozone treaties, monetary policy could not be tailored specifically to each country. When countries are heading toward default, monetary policy can be used to devalue their currencies, eliminating debt to some extent. Currency devaluation beyond a certain limit is not beneficial, however, and can end up hurting the economy more than it helps. At the limit of currency devaluation, the government’s excessive printing of money puts the actual value far below the amount of revenue the government could collect through taxes at lower inflationary levels. A theoretical balance can be met by printing a sufficient sum of currency to eliminate debts and stimulate exports, while not overly debasing the currency through inflation.

Unlike companies, countries do not simply default and go into bankruptcy. As Rogoff and Reinhart observe, “Country default is often the result of a complex, cost-benefit calculus involving social and political considerations, not just economic and financial ones” (p. 51). The cost-benefit analysis of default is unique to each
individual country. When a monetary union is ancillary, the complexity only multiplies. In the current situation the fate of not only Greece, but the entire EU economy, is being decided by the most powerful players: Germany and France. Nonetheless, enforcement power by these countries remains limited. Sovereign debt is issued by each nation’s individual government, and therefore each government can assess its options and make its own default decisions. Outright default is usually avoided as often as possible, and Greek history shows that default leads to long spans of isolation from capital markets and very expensive future borrowing. An outright default would limit Greece’s ability to pay for its basic necessity imports from other countries.

Because they held so much Greek sovereign debt, Germany and France also had good reason to avoid a Greek default. In a way, they were bailing themselves out. The current German Chancellor Angela Merkel and then French President Nicolas Sarkozy were committed to saving Greek sovereign debt at almost any price. European leaders saw the issue in a very slanted way: Greece would use bailout funds to pay off its debt, much of which was owed to Germany and France. Unfortunately, the Greek problems were based in social, political, and cultural traditions, and the bailout was just throwing good money at bad money in an attempt to buy political reform. German and French officials did not want to let Greece default, as their own banks would have suffered the most, and Merkel and Sarkozy were doing everything in their power to get all European countries to pay for their own bank failures and poor lending decisions (Schuman).

At a certain cost-benefit point that the European community was approaching, the funds needed from the EU to buy political and social reform far outweighed the benefits of saving Greece. In a traditional country with its own currency, the cost-benefit analysis would be much different, and the risk of contagion and monetary devaluation for other countries would be lessened. The monetary euro union also restricted Greece’s available options for avoiding default; Greece could not fund itself through inflation and currency devaluation.

In the EU, exchange rates remained relatively constant without any ECB stabilizers from 2007 to 2010, even though many member countries were faltering. In 2007, while the U.S. financial sector was crumbling and the U.S. dollar weakened, the euro was seen as a much safer currency comparatively, and this perception lulled investors into a false sense of security. Many American hedge funds accurately gauged the oncoming risks in the euro and began selling it as fast as possible. Many hedge fund managers were shocked when euro prices did not plummet, as China had been buying up the fire sale of euro currency. With its excess reserves and already heavy reliance on the U.S. dollar, China was purchasing the euro without assessing the future risks associated with the currency. A new complacency was brought to the ECB and Eurozone, which made them believe their currency was the safest in the world. As the sovereign debt contagion spread to Italy and Spain in January 2012, the euro began to show signs of strain, and exchange rates against the dollar fell to a record 16-month low of $1.28 (David).

**Contagion**

Although European authorities were correct when they judged Greece’s sovereign debt not large enough to threaten the EU’s existence, Greece’s situation was a big enough part to threaten the stability of larger European countries that were also overburdened with debt. These larger debtors could potentially ruin the EU and euro currency. Greece accounted for only approximately 5 percent of European sovereign debt, at $400 billion. Spain, plagued with a 20 percent unemployment rate, trumped Greece’s sovereign debt in 2010 with a total of $800 billion. Spanish banks also held Portuguese sovereign debt of approximately $35 billion in 2010, with equal portions also being held by French and German banks (Groendahl).

Italy, the third largest economy in the Eurozone, has approximately $2.6 trillion in national debt (20 percent of EU sovereign debt), and is teetering on the edge of a debt crisis as well. Italy needs to gain an additional $520 billion in short term debt in 2012 to roll over interest payments (Walker et al.). As shown in historical debt levels dating back to 1995, Italy’s debt-to-GDP was unsustainably high, and this trend was intrinsic in the high government
bond yields. A uniform trending decrease in bond yields and reduction of risk premiums occurred as the EU formed and as a false sense of economic stability was created.

If the exposure to Greek debt was not large enough to topple just about every French or German bank, a default by either Spain or Italy would have been more than enough to ensure a massive banking crisis. Almost instantaneously the ECB would also have become insolvent, and the euro would have undoubtedly fallen. The European Central Bank, the controller of the euro’s monetary policy (and fittingly ruled by the Germans), also remained at an elevated risk, as it was overlooked by EU political leaders. The ECB itself held over $60 billion in Greek sovereign debt, as well as holdings from bond exchanges with many of Europe and Greece’s larger banks, aimed at solving capital problems. If Greece were to default, the banks would have owed the ECB the bond values, which could create insolvency in both the original banks as well as the ECB (Lewis, p. 143).

Many knowledgeable investors realized the risks of European sovereign debt well in advance and took positions in Credit Default Swaps (CDSs). According to the Depository Trust and Clearing Corporation (DTCC), CDSs referencing Greece sovereign debt total approximately $8 billion. Italy, Spain, and Portuguese CDSs totaled upwards of $50 billion at the beginning of 2010, well before any media or ECB attention focused on these countries. The Greek CDS market remains relatively small and would be unable to collapse a systematically important institution, but if larger sovereign defaults occur, the underwriters of CDSs may also fall into financial trouble, similar to the AIG collapse in 2008 (Davidson). Although the unregulated CDS market has only fallen apart once, its existence is still measured in decades. Before it is too late, strong and definitive market regulations and clearinghouses should be established.

By late 2011, the EU and ECB formulated a second bailout plan with a much broader scope. European policymakers finally realized that the Greek sovereign debt crisis had vast implications beyond Greece; by putting off the problem for four years, the leaders of the Eurozone had allowed the entire monetary union to become infected. Merkel and Sarkozy were not prudent in their new plan for Europe, which still centered on the fact that, ultimately, French and German banks were the main benefactors of the bailouts, which would result in a grave situation in the case of outright default. In his 2011 editorial “The Euro’s PIG-Headed Masters,” Ken Rogoff observed, “Instead of restructuing the manifestly unsustainable debt burdens of Portugal, Ireland, and Greece (the PIGs), politicians and policymakers are pushing for ever-larger bailout packages with ever-less realistic austerity conditions. Unfortunately, they are not just ‘kicking the can down the road,’ but pushing a snowball down a mountain.”

The Second European Bailout

At the heart of the new bailout, the same social and political reform problems in Greece remain, and futile austerity measures continue to be forced upon the corrupt and contracted Greek economy. In spite of the first IMF Emergency Bailout package in 2010, little progress had been made by the end of 2011. Tax reform failed to bring any real gains in revenue, and the pension system continued at unsustainable levels. The original IMF and ECB bailout of Greece can be called a failure. The European authorities did not act quickly to contain the Greek sovereign debt crisis, which spread like a wildfire across southern Europe. Austerity and political reform required by the second bailout have continued to squander valuable funding.

A large part of the new bailout was based on a proposed 60 percent debt haircut, or voluntary forgiveness by Greek sovereign debt creditors. When the plan was announced in late 2011, reassured markets quickly became less volatile, as investors believed progress was finally being realized. Over the next six months, extending into 2012, creditors would discuss the proposed controlled default, which would avoid the CDS triggers and aim to contain the crisis from spreading to other weak Eurozone economies.

According to Angela Merkel in a January 2012 news conference, “The Eurozone’s first obligation this year is to resolve a second Greek program and finalize these negotiations with the banks so that we can then concentrate on structural problems in the Eurozone” (Brown
Merkel also pointed out that she admired Italy for its quick new governmental reforms, as Italy moved into position to try to save itself from the Eurozone's growing debt infection. Merkel and Sarkozy proclaimed that the second Greek bailout package must be set first, before other European sovereign issues could be considered. Investors lacked reassurance, and shortly after the plan's announcement European bond yields rose back to record levels and reflected the still dire nature of the situation.

In spite of the political motivations throughout Europe, many educated voices around the world spoke up and pointed out that Greek debt will remain un-payable and threatening to the well-being of all European countries. “Greece should default . . . you can’t jump over a chasm in two steps,” said Mario Blejer, former controller of Argentina’s Central Bank after its 2001 default of $95 billion, the largest sovereign default in modern history (Raszewski and Russo).

It soon became clear that, as with the first bailout, efforts to balance Greece’s budget had made little progress, and Greek unemployment exceeded 18 percent (Granitsas et al.). The Greek economy was in a clear contraction due to gross mismanagement and inefficient regulation. Nevertheless, EU and Greek authorities assured the public that everything was fine. A Greek official in the Finance Ministry proclaimed on January 12, 2012, “We are completely on track. Exploiting the momentum, by the end of the next week we could have the final outline for a deal with the private sector” (“Final Outline of . . .”).

The outlined deal would cut Greece’s total sovereign debt from over $450 billion to $330 billion, while reducing yearly interest service by $7 billion a year. Much of the $330 billion would also be exchanged for increased maturities of up to 30 years, and minimal coupons of less than 5 percent, half of current Italian debt interest rates. Even before a formal offering had been reached by some creditors, many others, including Vega Asset Management hedge fund, had ceased talks and left the steering committee to negotiate the agreement with Greece (Wilkes). Sarkozy and Merkel devised a 60 percent haircut on their own accord, and a poorly disguised traditional sovereign default was crafted through painstaking private negotiations with creditors. The steering fund committee, made up mostly of large French, German, and Greek banks, was created to abide by the voluntary debt forgiveness guidelines originally proposed. Vega Asset Management was just one voice on the board, but many other hedge funds have significant positions in sovereign debt markets that could topple bond markets if intentionally pushed in the wrong direction (Wilkes and White). The simple fact remains, however, that creditors can reduce debt on a voluntary basis only. If enough creditors fail to accept, debt will be reduced only in small amounts, and Greece would still default when the debt matured. In Ken Rogoff's editorial, “A Gravity Test for the Euro,” he argues “[The proposed] haircut for private-sector holders of Greek sovereign debt is not sufficient to stabilize that country’s profound debt and growth problems.”

By March 20, 2012, more Greek sovereign debt, totaling $20 billion, would mature, requiring additional bailout support to avoid default (“Greece nears . . .”). As of January 2012, Greece had received $97 billion from the original IMF bailout, and will receive another $120 billion regardless of the level of debt forgiveness over the next 12 months.

The private sector involvement in the debt forgiveness plan was based on bond holders’ individually accepting conditions and taking a voluntary cut of their debt holdings, which was unprecedented in the history of sovereign default. Time and time again over the past seven hundred years, countries have exercised the ability to restructure debt by altering and amending laws and regulations. Creditors might own the originally issued three-year bonds, and would have no recourse if the government decided to restructure their investment into ten-year maturities. In these scenarios, a default does occur, and the country’s credit rating plummets, impacting future borrowing, but the cost-benefit decision of default reveals that this is the best available option. In the case of Greece at the beginning of 2012, the scenario and cost-benefit analysis are exactly the same. A controlled default and extension of bonds for even ten years would allow Greece the critical time needed for fundamental political and social reform. Protests would ease; the coun-
try would be in economic recession, but its course would be definitive.

Significant social, political, and austerity programs still need to be implemented, or the Greek people will experience devastating consequences as their country regresses to the level of a developing nation. Greek CDSs would be triggered, but global financial markets would be able to absorb the impacts, while the Eurozone could concentrate on the much larger issues at hand and solve the problems that could otherwise crash financial markets and credit around the world. In addition to preparing for an imminent Greek default, the Eurozone and stronger economies must implement sturdy firewalls to keep Spanish and Italian debt from contagion.

The Failure of the Euro

A monetary union without a consistent fiscal union, such as the EU, was formed in a period of economic growth without sufficient contemplation of what might happen in the case of economic contraction and sovereign default of member countries. Eurozone leaders failed to consider the world history of sovereign default and banking default and allow for the implications of currency crises. In a 2012 Reuters poll of 64 economists, only ten believed that the Eurozone would collapse before year-end (Shuman). It may be in the best interest of Eurozone countries to keep the euro intact until economies stabilize. However, beyond the end of the current European financial crisis, the Eurozone will require alterations in order to advance and avoid the emergence of different (but not new) forms of economic anguish. The Eurozone lacks a level financial playing field. Every country must have a controllable fiscal and monetary policy in order for world financial markets to compensate for each country’s unique economy.
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