

The Greek Sovereign Debt Crisis:  
Politics and Economics in the Eurozone

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## Abstract

The Greek sovereign debt crisis has required multiple controversial bailouts, austerity measures that have caused Greek citizens to riot in the streets, and tense political negotiating in the eurozone. However, it is only one part of a larger problem of economic stability and political unity facing the European Union today. This paper seeks to answer three main questions: (1) what were the causes of the Greek sovereign debt crisis, (2) what are the potential policy solutions to the Greek debt problem, and (3) what are the implications of the crisis on the future of the European Union as a whole? Using an institutionalist approach, I analyze both the policies of the EU (in bailing out and financially strengthening Greece) and the institutional defects of the Eurozone (e.g., the ECB has limited power and banking regulations are still national) according to the interests of major European political actors. I evaluate proposed solutions according to which would present the greatest benefits for the fewest costs, in terms economic competitiveness and efficiency and political feasibility. I find that the Greek debt crisis was caused largely by incentives created by the European political environment and secondarily by the institutional structure of the Economic Monetary Union. Thus, to move forward, the European Union must take an active role in restructuring its institutions to promote both economic and political convergence. Correspondingly, it must develop strong political leadership, a polity that identifies with the European project, and a democratic process that provides legitimacy without forgoing its technocratic efficiency.

## Introduction

European politics is currently consumed by discussion of economic problems in the eurozone. Though the euro itself remains strong, Greece has required multiple bailouts from eurozone Member States, and economies across Europe (that is to say, the European Union) have exhibited sluggish economic growth since the financial crisis of 2008. While the European Union was designed as a political project meant to promote economic growth, unite the countries of Europe and ensure peace and democratic rule, the “European project” has also produced polarization between those who wish to see the EU succeed and those who want Member States to retain power. In the years prior to the Greek crisis, the euro was seen as a symbol of success of the European project, but the failure of the euro to ensure economic stability throughout Member States – particularly peripheral countries like Greece – has now become a symbol of EU failure. This crisis, therefore, presents a challenge to European cohesion and to the ability of democracy to respond to international problems.

How might this crisis be resolved? More specifically, what policies are political leaders most likely to pursue to resolve the crises? In order to answer these questions, one must first consider the relevant institutional and political background of the Economic Monetary Union (EMU) and the causes of the crisis. After explaining my methodology and normative bias towards the theory of historical institutionalism, I will discuss the convergence criteria and the Stability and Growth Pact (SGP), two mechanisms in the EMU’s institutional setup that were unsuccessfully designed to ensure economic convergence across Member State borders.

Second, I will explore three narratives – an economic narrative, a political narrative, and a Greek narrative – that seek to explain the causes leading to the Greek debt crisis. While the

economic narrative asserts that the EMU was a bad idea from the start because eurozone countries were not economically integrated enough to form a currency union, the political narrative argues that subsequent political decisions undermined the effectiveness of the EMU. These include the lenient application of the convergence criteria that allowed Greece and other problem countries to join the euro at all, the undermining of the Stability and Growth Pact (SGP), and a lack of strong political leadership, particularly in Germany, since the beginning of the financial crisis. The Greek narrative, meanwhile, emphasizes the role of French and German banks in financing the Greek debt crisis to begin with. I argue that the political narrative provides the most comprehensive explanation of the causes of the Greek sovereign debt crisis, as political decisions taken after the convergence criteria and SGP weakened the economic stability that would have otherwise been enjoyed by eurozone Member States, though the Greek narrative has relevant implications for the future of the eurozone because it claims that wealthier Member States contributed to the crisis and therefore have a responsibility to help reduce Greek debt.

The third section of this paper analyzes the contemporary interests of major political actors in Greek debt negotiations: the national leaders of Germany, France, and Greece. While each has unique preferences, resources, and constraints, certain interests overlap between the actors. Notably, while France and particularly Germany would prefer not to give Greece bailout loans, each has an interest in ensuring the stability of the eurozone by managing contagion and avoiding a Greek default. To that extent, French and German leaders have granted bailouts, but German Chancellor Angela Merkel has made certain that they be conditioned on austerity measures to help prevent moral hazard and to try to assuage German voters.

Section four addresses the policies that the European Union has undertaken in attempts to address the Greek debt crisis. Specifically, these include bailout loans and “haircuts” on

investors that hold Greek bonds, guaranteed liquidity for banks that hold Greek debt, and structural reforms for Greece. I argue that these measures have been direct results of the political interests defined in section three, but that they will be insufficient to prevent future crises given the current institutional structure of the EMU and divergent fiscal policies and productivity levels across the eurozone.

In the fifth section, therefore, I discuss the need for broader institutional reform at the European level. In order to prevent future crises, the international banking system in Europe needs supranational banking regulations, the EU and ECB must provide a credible commitment to insure the debts of Member States, real fiscal and economic convergence must be attained, and Greece and other peripheral countries need help boosting productivity. This section will analyze the political feasibility of such reforms as opposed to allowing the eurozone to disintegrate partially or entirely. I argue that just as political interests dominated economic decisions leading up to and during the crisis, European leaders will pursue institutional reforms only as far as their political interests compel them to. In conclusion, I will speak to the need for long-term democratic legitimacy in European institutions to better address future crises.

### **Methods & Theoretical Background**

This research is a qualitative analysis of role of political incentives in the Greek debt crisis. I first identified the major political actors involved in the crisis and researched their interests, resources, and constraints. Drawing significantly on Paul Pierson's description of historical institutionalism, I analyzed those actors in terms of their institutional situation in

European politics (notably at the national level) then applied that analysis to the causes of the Greek debt crisis, its solutions, and its implications on the future of European institutions.

Historical institutionalism mediates the debate between functionalists and intergovernmentalists over European integration. Historically, functional integration has advanced, but it has been the result of intergovernmental bargaining. However, intergovernmentalism does not sufficiently explain why Member State interests shift over time. Thus, historical institutionalist scholarship is compelling because it recognizes that political development “must be understood as a process that unfolds over time” and that institutions – “formal rules, policy structures, or norms” – help determine the viewpoints of rational actors within the European system (Pierson, 1996, 126).

The emphasis on institutions also helps explain the role of “soft,” cultural factors in decision making, since cultural norms are a type of institution. However, it accepts that leaders ultimately make decisions – as reflected in the intergovernmental bargaining that Europe has seen between Angela Merkel and Nicolas Sarkozy, with Herman Van Rompuy and José Manuel Barroso playing secondary roles – and that their interests will be determined by the resources and constraints of their positions, such as the need to satisfy national electorates.

This does not presuppose the likelihood that Chief of Government preferences can change over time, or the role that European institutions can play in creating unintended consequences for Member States – which ultimately explains how European integration has been achieved in incremental steps that do not present egregious attacks on Member State sovereignty.

Given the advantages of these nuances, my research and analysis of the causes of the Greek debt crisis, the policies that have been adopted to manage it, and the institutional reforms

that could come as a result of it has been heavily influenced by the framework of historical institutionalism.

### **EMU Design**

The EMU was created in three discrete developmental stages between 1990 and 1999, and was based on German preferences for strict fiscal policies. The convergence criteria for countries hoping to enter the EMU after the completion of the third and final stage includes four main points: (1) price stability (average inflation rate of no more than 1.5% above the average of the three best-performing Member States); (2) low interest rates (no more than 2% above the three best Member States); (3) minimal annual budgetary deficits (not exceeding 3% GDP) and debts (not exceeding 60% GDP); and (4) currency stability (within the narrow band of exchange rates, with fluctuations of less than 2.5% around the central rate for at least two years with no competitive devaluations). In addition, the Stability and Growth Pact, a Franco-German deal established in 1997, aims to ensure budgetary discipline. Near the debut of the single currency in 1999, Germany proposed a Stability Pact “to prevent governments from running large deficits once [the] EMU was launched. This was opposed by the French socialist government, which had been elected on a platform that was critical of the monetarist [neoliberal] design of EMU” (Hix & Hoyland, 2011, 253).

Eventually, Germany gave in to other concessions and the Stability and Growth Pact was reached as a compromise. Its purpose is to coordinate national fiscal agendas on a European level, and it “defines the procedures for multilateral budgetary surveillance (preventive arm) as well as the conditions under which to apply the excessive deficit procedure (corrective arm)”

(European Central Bank, 2011c). Together with the strict economic convergence criteria, the Stability and Growth Pact was supposed to create the fiscal and economic coordination optimally needed for a currency union.

### **Causes of the Greek Debt Crisis**

The initial part of my research seeks to explain the inevitability of the Greek debt crisis, given the institutional setup of the EMU. In order to analyze the competing perspectives on the causes of the crisis, this section will give a basic timeline of the relevant events preceding the Greek debt crisis itself, followed by an analysis of three “narratives” that interpret those events in different ways. The last subsection will then evaluate those three narratives according to which best explains the inevitability (or lack thereof) of the crisis and the reactions of political leaders and markets to the way the crisis unfolded.

### **Conditions Preceding the Crisis**

**Weakening of structural economic supports.** For reasons that vary according to interpretation, the convergence criteria and the SGP did not successfully prevent future financial and economic crises. The convergence criteria, simply put, were applied more strictly to some countries than others. This allowed Greece to enter the eurozone when “in reality, it had not met the... convergence criteria of 3 per cent of GDP ceiling on the government deficit” (Featherstone, 2011, 199). The Greek public debt level has also been consistently high: “it has fluctuated around the equivalent of 100 per cent of GDP since 1993” even though Greece did not join the eurozone until 2001 (Featherstone, 2011, 198). Because the convergence criteria were applied

incorrectly, Greece was allowed to join – which, depending on one’s interpretation, is either a structural failure of the criteria or a political failure of European leaders.

This is not to say other countries did not fudge the convergence criteria as well. In Greece, however, even after weak economic convergence to begin with, “governments of 2001-2009 did not implement sound economic policies, thus allowing *further* deterioration of fundamentals” (Arghyrou & Tsoukalas, 2011, 180). Similarly, the Stability and Growth Pact lost a great deal of power in 2002 and 2003. While the French and German central bank governors preferred lower interest rates at the time, they “were easily outvoted by a coalition of small states and the ECB Executive Board.... German and French governments had to run public deficits in this period, and hence break the rules of the Stability and Growth Pact” (Hix & Hoyland, 2011, 263).

Under the normal rules of the Pact, France and Germany would have faced sanctions for running large deficits. However, in November 2003, France and Germany persuaded enough other Member States to “suspend the excessive deficits procedure. The Commission was so infuriated by this procedure that it took a case to the [European Court of Justice]. The ECJ ruled in support of the governments. As a result, for all practical purposes the Stability and Growth Pact is now moribund” (Hix & Hoyland, 2011, 267).

**Ties to 2008 international banking crisis.** In addition to these institutional changes within the EMU, the international banking crisis of 2008 is closely linked to the Greek sovereign debt crisis. The specifics of the banking crisis are different in different countries but Stan Maes, a member of the Chief Economist Team of the Directorate General Competition, writes:

“In light of the heavy regulation that applies to banks and their role in the monetary system, the main causes of the crisis indeed seem to be monetary policy (which, with the

benefit of hindsight, was far too lax, leading to the creation of major asset price bubbles), flaws in the regulatory design... and inadequate supervision” (Maes & Kiljanski, 2009, 13, emphasis added).

The financial crisis was particularly important in Greece because of the country’s uncompetitive economy, administrative weaknesses, and rampant tax evasion in key sectors. To illustrate this point, the European Commission estimated in 2006 that 30% of Greek taxes – or 3.4% of the Greek GDP – were unpaid (Featherstone, 2011, 196). When the international credit crisis spread in 2008-2009, Greece’s “record of low reform capacity was matched by inherited economic weaknesses that made Greece very vulnerable... Thus, the Greek economy has lacked competitiveness and sustained significant current account deficits in foreign trade and commerce” (Featherstone, 2011, 198).

When the Greek government subsequently became incapable of paying back their debts, “lower than anticipated returns on the Greek project gradually reduced the price of Greek bonds, with losses accelerating significantly in the wake of the global credit crunch” (Arghyrou & Tsoukalas, 2011, 180). In the wake of the credit crisis, however, the Greek government took no corrective action, perhaps in anticipation of the upcoming Greek elections. In other words, the Greek government acted irresponsibly with its fiscal policy and debt accumulation, the consequences of which were accelerated by economic weaknesses that became apparent during the global credit crisis.

**Start of the debt crisis and Treaty complications.** The structure of the EMU also created perverse incentives for banks to buy Greek bonds, exacerbating the risks of illiquidity for the banks and unsustainable borrowing for Greece. Normally, investors incorporate risk factors into the interest rates they accept on government bonds – e.g., risky Greek bonds demand a

higher interest rate than “safe” German bonds. Paul Krugman explains the distortions that the EMU created in this pricing mechanism:

“As interest rates converged across Europe, the formerly high-interest-rate countries went, predictably, on a borrowing spree. (This borrowing spree was, it’s worth nothing, largely financed by banks in Germany and other traditionally low-interest-rate countries; that’s why the current debt problems of the European periphery are also a big problem for the European banking system as a whole.)” (Krugman, 2011).

The market assumed that the sustainability of Greek debt would be indirectly guaranteed by the other member states with more stable monetary policies like Germany, while the ECB would ensure that Greek debt would not become inflated in the first place (Schulte, 2011). Even when the new Greek finance minister, George Papakonstantinou, announced on October 20, 2009 that the Greek public deficit was three times what the previous government had reported (12.8% GDP instead 3.6% GDP as had been believed), and it became clear that Greece would not be able to pay back the yields on its bond, markets expected that Greece would receive a bailout immediately.

Interestingly, the current European Treaty (last amended by the Lisbon Treaty, which entered into force in 2009), includes a “no bailout clause.” Article 125 states that individual member states and the European Union “shall not be liable for or assume the commitments... or public undertakings of any Member State” (European Union, 2010). Clearly, however, the market never believed Article 125. Despite the restrictions in Article 125, the French and German government – whose banks held substantial portions of Greek debt – could not allow it to default. In contradiction to the “no bailout clause,” Article 122 states that where a Member State “is in difficulties or is seriously threatened with severe difficulties caused by natural

disasters of exceptional circumstances beyond its control,” the Union may offer financial assistance to that Member State (European Union, 2010).

In essence, then, the current euro crisis “is a wrestling match over who will ultimately bear these bank losses. So far, EU governments have decided that banks’ bondholders must be protected at all costs, preferring to impose losses on taxpayers instead” through costly bailouts (Legrain, 2011). So far, Greece has received bailouts only in the form of voluntary loans, not direct financial aid, adhering to the letter if not the spirit of the Treaty.

### **Narrative 1: Economic Perspective**

In discussing the sovereign debt crisis and the factors that led to it, many economists argue that the current crisis has its origins in the founding period of the Economic Monetary Union and the design flaws inherent in the European monetary system. Because the Member States involved in the eurozone have vastly different fiscal and economic policies, they do not comprise what economists call an Optimal Currency Area (OCA). Therefore, today’s crisis was predictable. In a free market, booms and busts are inherent. When prices and wages rise during a boom, a country needs flexibility to bring prices and wages back down to get back in sync with its trading partners. Normally, countries with sovereign monetary policies can simply print more money and devalue their currency – “reduce its value in terms of other currencies – and you would effect a de facto wage cut” (Krugman 2011). Otherwise, it is necessary to have fiscal integration, labor mobility and wage lowering – but politicians are loathe to promote a wage cut within their constituencies for political reasons. As Paul Krugman states:

“Europe isn’t fiscally integrated: German taxpayers don’t automatically pick up part of the tab for Greek pensions or Irish bailouts. And while Europeans have the legal right to

move freely in search of jobs, in practice imperfect cultural integration – above all, the lack of a common language – makes workers less geographically mobile than [for example] their American counterparts” (2011).

In other words, the convergence criteria and Stability and Growth Pact were not strict enough to keep state fiscal policies and economic cycles from diverging. In the case of Greece, this situation led to a financial disaster in a country that had long had high debts and periods of high inflation.

The 2008 banking crisis and Article 125, according to economists, only exacerbated the aforementioned structural problems. The impacts of the banking crisis on Greece only showed how vulnerable and uncompetitive the Greek economy was. In addition, Article 125 provided false protection for European economic leaders to think that the EMU was sustainable, but since markets did not believe the no bailout clause, politicians were merely deluding themselves that reckless Greek spending permitted by the single interest rate would not lead to the brink of Greek default – the danger of which has still not passed.

If the eurozone was obviously not an Optimal Currency Area, then, why did the project proceed with these inherent structural flaws? Economists say that it is because “the idea of the euro had gripped the imagination of European elites. Except in Britain... political leaders throughout Europe were caught up in the romance of the project, to such an extent that anyone who expressed skepticism was considered outside the mainstream” (Krugman, 2011). Had the European political leaders at the time paid attention to economic rationality, economists say, Greece and the eurozone may not be facing the same financial crisis today.

Taking this narrative one level further, many economists would probably argue that to solve the eurozone’s problems, especially as it relates to Greece, the euro ought to be restricted

to economies that have truly already integrated. If Greece remains in the eurozone, it should be because it has decreased spending on social welfare and wages and increased its competitiveness – not because there is political will to keep Greece in. Since it will be impossible for Greece to integrate itself rapidly, then, it ought to be allowed to default or exit. As Jeffrey Miron of Harvard University writes, “Greece will never change its misguided policies if the E.U. and IMF infuse it with new cash, just as no teenager who has overspent an allowance will reform if the parents merely expand that allowance” (2010).

### **Narrative 2: Political Perspective**

**A different take on OCA theory.** A political perspective addresses the origins of financial crisis differently. Even accepting OCA theory, it is possible that the benefits of the single currency were great enough that they outweighed the costs in terms of economic flexibility. Competitive devaluations, for example, are generally accepted to be detrimental to an economy in the long run. This is because devaluation, while lowering the price of exports in international markets, increases the price of imported goods. This raises the costs of production and demands for domestic wages, the long-term consequence of which is “higher prices and lower economic output. The exchange rate is thus an inefficient fix for countries experiencing economic difficulties” (Hix & Hoyland, 2011, 247).

Giving up money-printing ability as a temporary macroeconomic tool, then, may not be such a high cost for countries with high levels of imports looking to join a currency union such as the EMU.

**Convergence criteria and Stability and Growth Pact.** Moreover, the convergence criteria and Stability and Growth Pact could have been sufficient to ensure economic integration

had it not been for later political decisions. Throughout the debt crisis, “the requirements of financial crisis-management have collided with political, legal, and emotional priorities. Indeed, the euro’s woes are as much about politics as finance” (The Economist, 2011a). Even from the beginning of the EMU, Europe’s economic policy has been shaped by political compromise:

“While [Frenchman Jacques] Delors’ aim was to design a project that would be irreversible, the governor of the German Bundesbank, Karl Otto Pöhl, wanted to be certain that the single currency would be as stable as the Deutschmark, arguing for constraints on national deficits and a fully independent European Central Bank” (Hix & Hoyland, 2011, 250).

This explains why the committee that designed the Economic Monetary Union and was chaired by Commission President Jacques Delors – a Frenchman – promoted a *German*-oriented design – i.e., strong convergence criteria and economic accountability (Hix & Hoyland, 2011, 240).

The Stability and Growth Pact, as mentioned above, was also the result of a political compromise designed to ensure a strong relationship between member states and European preferences. Had it been interpreted as the EMU’s founders ostensibly intended and not weakened in 2002-2003, the Pact might have been strong enough to support economic convergence. Rather, the decisions taken after the EMU was in force altered the founders’ intentions and integrative supports. A similar history can be seen with the convergence criteria and the decision to let Greece into the EMU to begin with. Had Greece refrained from joining the euro until it was more integrated into the economic cycles of the rest of Europe, it might have avoided the troubles of its current sovereign debt crisis. Instead, Greece inaccurately reported its public debt and deficits, the European Union did not ensure accountability in those numbers, and Greece received the benefits of a single currency that it would otherwise be denied.

**Political leadership and crisis management.** Political considerations also affected the course of events after the announcement of Greece's actual public debt. Some political leaders, particularly German Chancellor Angela Merkel, have come under criticism that their indecisiveness in granting a Greek bailout accelerated the severity of the euro area crisis (Pidd, 2011). After all, investors "had been pricing, even well into the crisis, Greek and other EMU bonds assuming a bailout. Hence, from the markets' point of view, a bailout would not be new and thus would not destabilize the eurozone further; instead the news was there was to be no bailout" (Arghyrou & Tsoukalas, 2011, 182).

Other German leaders would likely agree with this assessment of Merkel's leadership. Former Chancellor Helmut Kohl, one of the leading architects of the euro and EMU, blames not only the Greek state but German Chancellor Angela Merkel as well. According to one visitor, Kohl complained that Merkel's actions have been "very dangerous" and that she is "destroying my Europe" (Müller, Pfister, & Schult, 2011). Kohl, who is a member of the Christian Democratic Union (CDU), the same political party as Merkel, later stated that he never made that comment. However, he also asserted that former Chancellor Gerhard Schröder, a member of the opposing Social Democratic Party who preceded Merkel in office, "was partly to blame for the crisis because he had agreed to a softening of the Stability Pact on fiscal discipline in the euro zone and had allowed Greece to join the euro in the first place" (Müller, et al., 2011, emphasis added).

Merkel's advisors have defended her actions arguing that Merkel is not alone among European leaders who have hesitated to cede more power to Brussels due to rising Euroskepticism among voting constituencies. Her government also faced a major election on May 9, 2010, and she was undoubtedly under domestic political pressure not to appear to "give

away” German money to Greece. However, “that is only half the truth. Merkel is also afraid of German voters. Rarely has Europe been as unpopular with German citizens as it is now, and getting people to accept the need for unpopular policies has never been Merkel’s strong point” (Müller, et al., 2011). Moreover, economic experts within Germany’s CDU, which has historically been very supportive of European integration, say that Merkel’s lack of plan for the euro will cause greater damages to the single currency.

To be fair, “successive German governments of all persuasions had been consistently stating over the years that if the circumstances ever arise, they will uphold the no-bailout clause” since the guarantee of a bailout would encourage Greece and similarly situated countries to spend recklessly, intensifying the crisis and causing a moral hazard (Arghyrou & Tsoukalas, 2011, 182). However, after the beginning of the crisis, leaders of eurozone countries with successful economies, such as Merkel, should have taken a strong stance to prevent “a double shift in markets’ expectations, from a regime of credible commitment to a future EMU participation under an implicit EMU/German guarantee of Greek fiscal liabilities, to a regime of non-credible EMU commitment without fiscal guarantees” (Arghyrou & Tsoukalas, 2011, 186).

Overall, this political perspective asserts that the EMU’s original protections against economic divergence among eurozone countries were deteriorated by politically-based decisions later in the EMU’s history. The most important of these were the weakening of the Stability and Growth Pact to make way for French and German interests, lenient application of the convergence criteria (which had been designed by fiscally-responsible Germany) to allow Greece in the eurozone at all, and Chancellor Merkel’s indecisive leadership which failed to reassure markets that their investments would yield returns.

### **Narrative 3: Greek Narrative**

The third narrative regarding the Greek crisis approaches the matter significantly differently than the first two, focusing on the role of northern European banks in the years after the euro was created, instead of the institutions that were created in the years leading up to the euro's debut. It is referred to here as the "Greek narrative" because it sheds light on the Greek perspective as the nation most directly affected from the sovereign debt crisis. This perspective differs from the economic narrative primarily because it offers no judgment regarding the initial creation of the eurozone or Europe's status as an Optimal Currency Area, but complements the political narrative in that it places emphasis on the credit boom and subsequent crisis rather than the EMU's creation.

This version primarily overlaps with the political narrative regarding the convergence criteria and the Stability and Growth Pact. Had the rules been followed dutifully, they may or may not have been sufficient to guarantee economic convergence. Since adherence to the rules was ultimately not achieved, however, the story of the European credit boom in the years after the euro's introduction is more important here. If one accepts that the leaders of the EU perceived their goal to be the further integration of member states into the European project, then it was in their political interest to allow Greece to accumulate huge debts with the low interest rates afforded by eurozone membership. This involved "German and French banks lending to the Greek government – some German corporations bribing Greek officials – European banks lending to construction firms and mortgage lenders, and the international bond markets lending to peripheral governments" (Manolopoulos, 2011, 154).

**Greece's role.** European politicians and commentators, particularly those in northern Europe, commonly contrast the financially responsible northern European countries like

Germany and France with the reckless, debt-accumulating southern European countries like Greece in order to justify avoiding massive intervention in the Greek economy, which is unpopular with voters. Jeffrey Miron sums up this opinion in writing that “a bailout harms the citizens of these [Northern European] countries, who did not live beyond their means. And a bailout harms Greece in the longer term by delaying adjustment of the fundamental flaws in its economic policies” (2010).

The Greek narrative accepts that, to an extent, Greece as a whole should take responsibility for its government’s irresponsible actions after the introduction of the euro. Greece has a history of buying social peace through “clientelist” governments – treating specific segments of the population as favored clients rather than making decisions based on the good of the nation. The Greek tax-collecting apparatus is incredibly weak, the civil service sector is large and inefficient, and domestic wages are too high to be competitive.

**Financing the crisis.** The problem according to this narrative, though, was also due in part to *northern* European banks (and the states that govern them) taking advantage of the sudden Greek demand for cheap financing. The financial sector within individual countries is heavily regulated, but during the economic “booms” of the early 2000’s following the creation of the euro, “the global financial system underpriced risk and misallocated capital.” As a result, French and German banks hold vast amounts of Greek debt, causing many to be illiquid and “depend on cheap ECB finance to stay afloat” (Legrain, 2011). In addition, politicians – including those from the supposedly-responsible north – have not put into place controls to contain banks with risky lending practices to the Greek government.

In contrast to the politically popular narrative that Greek political corruption alone brought financial problems to itself and to the rest of Europe, this narrative emphasizes that

Europe's current fiscal woes were also financed by northern European banks and encouraged by EU leaders as a representation of European integration.

**Greek debt, German exports.** The final component of the Greek narrative is that, while Greek wages increased significantly despite few productivity gains after Greece joined the euro, Germany maintained its competitive economy by relying on growing private debt in Greece. It was on the whole beneficial for the German economy for banks to under price the risk inherent in Greek debt, as Greek households then used that credit to purchase German exports. To that extent, then, the debt crisis in Greece has to do with private debt as well sovereign debt.

Lapavitsas, et al. describe this situation succinctly: In the last two decades, peripheral countries “were encouraged to improve competitiveness primarily by applying pressure on their workers.... [But] Germany has been unrelenting in squeezing its own workers throughout this period” (2010, 323). This is not to imply that workers in peripheral countries have been impervious to downward pressures on pay and conditions, but with minor exceptions in 1997 and 1998, nominal wages in Germany have consistently increased more slowly than wages have in Greece or in the eurozone on average, as indicated by Figure 1 (Eurostat, 2009). German workers, meanwhile, have “systematically lost share of output” (Lapavitsas, et al., 2010, 323). However, as Figure 2 shows, German productivity compared to the European average, has essentially stagnated (Eurostat, 2012).

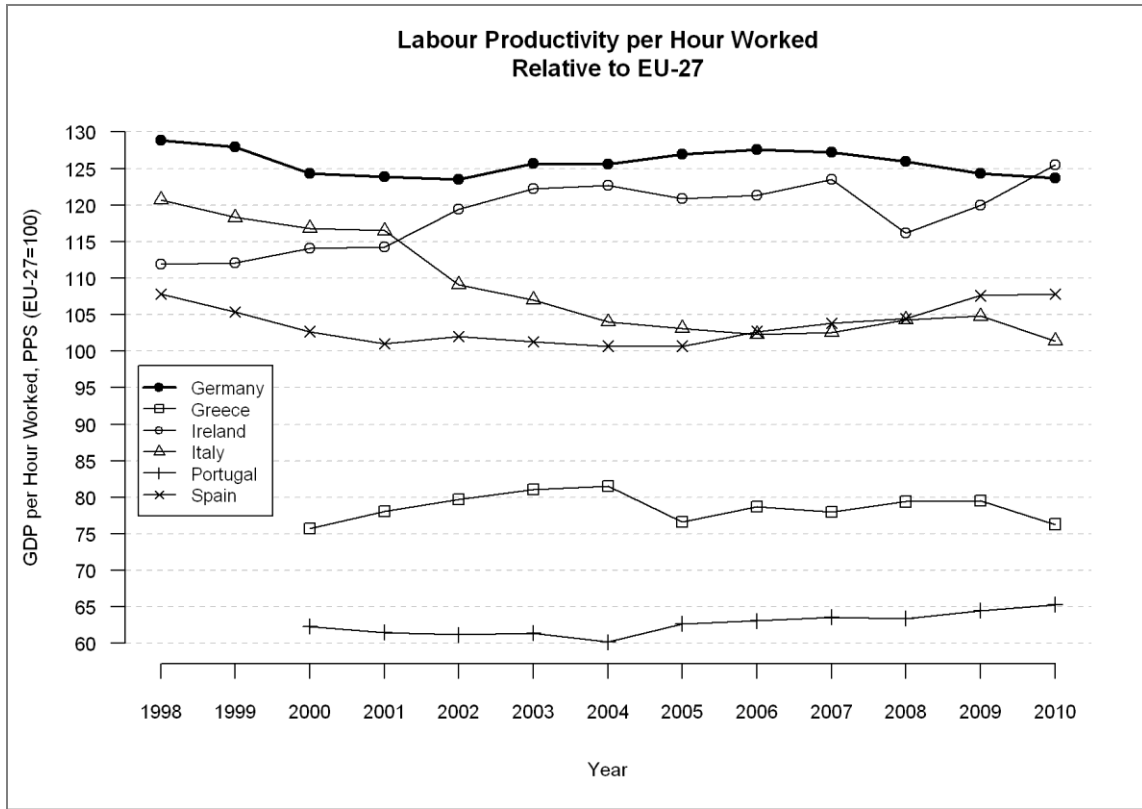


Figure 1. Source: Eurostat, as cited in Caporaso & Kim, 2012, 16

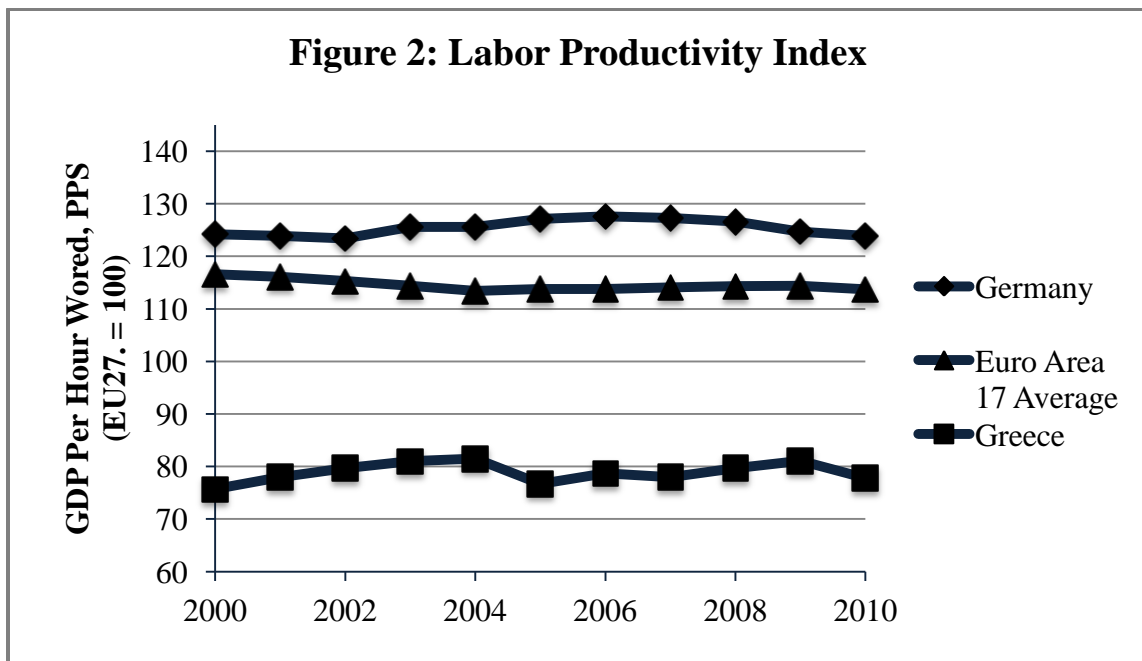


Figure 2. Source: Eurostat, 2012

By themselves, neither Figure 1 nor Figure 2 is particularly unusual. Nominal wages that increase slowly are consistent with the popular narrative that Germany has been responsible with its spending, and stagnant productivity compared to the rest of the eurozone could ostensibly mean that other eurozone economies have simply been increasing productivity faster than Germany has still been increasing its productivity. However, German competitiveness has continued to rise within the eurozone, due primarily if not solely to increased exports to the eurozone, including to the periphery. Structural current account surpluses in Germany have been mirrored by current account deficits in peripheral countries (Lapavitsas, et al., 2010, 322-324).

The implications of this on the future of the Greek debt crisis is that austerity and wage cuts for Greece will lower inflation and foster competitiveness in the eurozone, but that would only be possible if German prices and wages were to rise relative to Greece and the rest of the eurozone – i.e., if Germany would become less competitive. That will not be allowed to happen, however, because the ECB will continue to hold rates too low for the needs of the eurozone as a whole in order to help the German economy. While too-low interest rates contribute to inflation bubbles in peripheral countries like Greece, if the ECB “allowed German inflation to surge, political support for euro membership in Germany could disintegrate” (Tilford, 2012). Helping Greece, then, puts Europe in a catch-22 situation, since Greece ultimately needs German support, but many of Greece’s problems have come from German competitiveness itself.

### **Evaluation of Causes**

Interestingly, in explaining the crisis, the economic and political narratives both emphasize the convergence criteria and Stability and Growth Pact; theoretical disagreements are

not based in disputes about facts. However, the economic argument asserts that these institutions were insufficient to begin with while the political argument stresses that the same institutions were merely co-opted later in their existence to be used for political gain. The Greek narrative differs slightly. It accepts that certain safeguards unsuccessfully encouraged economic integration, and emphasizes instead the interests of France and Germany financing the crisis and taking advantage of mounting Greek public and private debt.

In my evaluation, the political narrative put forward here gives a better explanation of the creation of the currency union, the problems that led to the Greek crisis, and the events during the crisis. The Greek narrative also presents a valid critique of Northern European actors and the implications of that on solving the Greek debt crisis today. This is not to say that the economic narrative is entirely untrue, but rather that the political perspective provides a more comprehensive explanation, incorporating much of OCA theory into an analysis of the rational choices that political elites made according to their institutional situations.

Obviously, economists are correct in that the convergence criteria and the Stability and Growth Pact were not sufficient to ensure economic stability within the European currency union. However, this does not prove that they *would not* have been sufficient had it not been for the later events that undermined their effectiveness: the weakening of the Stability and Growth Pact due to French and German interests, and the inconsistent application of the convergence criteria that allowed Greece to join the euro at all. As such, I find that the economic narrative's assertion that the Greek debt crisis was inevitable from the beginning of the EMU is not sufficiently proven.

Additionally, the political perspective provides an explanation of how the Greek crisis itself developed, which the economic narrative takes as granted. In actuality, as Simon Pinder

puts it, “the economic cycle [is not] a force of nature that cannot be influenced by government policy aiming at adequate convergence” (Pinder & Usherwood, 2007, 77). The economic narrative, however, provides no explanation why the markets did not react strongly directly after the Greek Prime Minister announced the incorrect accounting figures, and Greek interest rates began to soar only after it became clear that German leadership did not immediately support a bailout.

Finally, the Greek narrative is valid to the extent that one accepts that northern Europe helped cause the Greek sovereign debt crisis. Since northern Europe did help cause the crisis, the Greek narrative is correct in its assertion that northern Europe *ought* to take partial responsibility for solving the problem. This is, of course, a different matter than saying that Europe has a compelling *interest* in solving the problem, which the next section shall show.

### **Contemporary Interests, Resources, and Constraints of Political Actors**

This section will analyze the current interests, resources, and constraints of Greece, France, and Germany. The Greek narrative may accurately describe Greece’s perspective that northern Europe ought to aid Greece, but the way French and German actors perceive their own interests as national leaders will more accurately explain their actions during the crisis. This section will outline those interests, while the following two sections will apply that analysis to the policies that have been adopted to handle Greek debt and the institutional changes that may be pursued to prevent future crises in the eurozone.

## Greece

Greek national leaders hope for Greece to remain in the eurozone, avoid default, and receive financial assistance with few or no austerity measures. Exiting the eurozone, while becoming more politically popular, is a bad idea economically. A Greek exit “would bring the mother of all financial crises” since all financial assets would leave Greece, most of the debt-holding private sector would go bankrupt, and the new Greek central bank would have very little credibility (Darvas, 2011b). This would lead to long-term consequences like high real interest rates and high inflation (Darvas, 2011b). These huge disadvantages would hugely outweigh the short-term gains that Greece would receive by exiting the eurozone.

If Greece defaults instead, “its economy may suffer in the short term. External credit will be [scarce] to non-existent, so Greece will have to live within its means. This will require slashed pay-scales and benefits for civil servants and drastic cuts in the number of such jobs” (Miron, 2010). Even if political leaders in actuality want to slash pay scales and reduce benefits for civil servants in an effort to make Greek products more competitive on international markets, overly zealous austerity is likely to lead to prolonged recession, while productivity increases “require investment and new technologies, neither of which will be provided spontaneously by liberalized markets” (Lapavitsas, et al., 2010, 326).

Finally, remaining in the eurozone with financial assistance from the EU, the ECB, and the IMF has thus far been conditioned on austerity. Domestically-elected politicians, however, are constrained in their positions by domestic politics. Austerity measures are so unpopular that Greek citizens have on multiple occasions rioted in the streets and gutted swaths of Athens and other cities.

One particularly telling example of the tensions Greek leaders face between domestic and international politics is that of former Prime Minister George Papandreou's proposed referendum on the second Greek bailout. While agreeing to restructure Greek debt and forcing private creditors to accept a 53.5% nominal "haircut," the European Commission, ECB, and IMF conditioned their continued aid on tax increases and heavy cuts to government expenditures. Bowing to domestic pressures, Prime Minister Papandreou announced a referendum on the deal on October 31, which the Greek public was certain to reject. Incensed, European leaders demanded that Greece decide "once and for all if it wanted to remain a part of the European Union and... the euro zone" (Donadio & Kitsantonis, 2011, A1). For Papandreou and other leaders, the response was "yes." Papandreou called off the referendum a few days after he announced it and resigned to make way for members of the opposition New Democracy Party to create a unity government.

Even though the referendum itself cast doubt on the Greek government's capacity to weather popular discontent with continued austerity measures, the subsequent political maneuverings restated – albeit indirectly – Greece's political commitment to the European project. The referendum also exemplifies the two-level game that domestic leaders face, both in Greece and northern European countries. Actors must attempt to consolidate the interests of national publics and international politicians to achieve successful policy outcomes.

While Greek leaders face many constraints on their interests, they do have some resources. The most important among these is that to a certain extent, German and French interests will align with Greek ones. Bailouts have been contentious and Germany's Chancellor Angela Merkel drives a hard bargain by insisting on austerity measures, but Greece has nonetheless received billions of euros in assistance. To an extent, Greece can simply wait for

Germany to come up with bailout plan, as Germany has done for economic reasons that will be discussed later (Caporaso, 2012).

The Greek elections on May 6, 2012, did little to change this situation, though they may have encouraged future Greek leaders to put more weight on the preferences of their domestic constituencies rather than those of European leaders. Initial results showed that the Socialists and the New Democracy Party – the two fairly moderate parties that supported the bailout and accepted its conditional austerity measures – together received the support of only 34 percent of the Greek public (Birnbaum, 2012). The three parties that received the most support (New Democracy, Coalition of the Radical Left, and the Socialists) are all pro-Europe, but with leaders from all parties adamant about their positions on the debt deals, a unity government will be difficult to achieve and a second round of elections is likely.

While these elections do not change what policies have already been adopted, they could have huge implications on how future leaders will approach Greek debt, and the eurozone as a whole. The political parties say that the new government must reflect the will of the people, who disapprove of the terms of the debt agreement. Breaking those terms, however, would mean an end of loans to Greece, leaving the state unable to pay wages and pensions. Current negotiations at the national level only exemplify domestic leaders' two-level game and the "clash developing across Europe between democracy and the demands of market forces" (Donadio & Kitsantonis, 2012).

### **Germany**

The situation for Germany, like Greece, is complex. Led by Chancellor Angela Merkel, German leaders hope to minimize moral hazard in the Greek debt negotiations (preferably with

no bailout whatsoever), ensure eurozone stability through preventing contagion, prevent investors from accepting undue losses on Greek debt holdings, and please domestic constituents to ensure political survival.

As the largest economy in the eurozone, Germany can offer substantial financial assistance to Greece, which affords it significant negotiating power. The constraints on Chancellor Merkel, though, come from two conflicting levels like those in Greece. On one hand, wanting to protect investors and ensure eurozone stability lends itself to offering bailout loans to Greece. Uncertain financial markets can spread contagion, which is bad for economies across Europe. On the other hand, moral hazard is inherent in bailouts and German voters, as explained in the political narrative, are loath to cede power to Brussels and give money to Greece in light of the popular – though not entirely accurate – narrative that the crisis has only to do with Greece's profligate spending and lack of productivity.

As the next section will show, Merkel has so far chosen a middle path between preventing contagion and preventing moral hazard. As there is virtually no popular support for a Greek bailout, she has balanced her preference of preventing too many losses to German banks with the necessity of pleasing domestic constituents, and has reluctantly agreed to grant bailout money only after extracting as many concessions from Greece as possible. Her indecisiveness has exacerbated uncertainty and contagion, but this has come as a direct response to the political constraints she faces.

## **France**

Roughly speaking, French interests have aligned with German interests for the majority of the crisis period. Like Merkel, French President Nicolas Sarkozy of the Union for a Popular

Movement (UMP) has had an interest in preventing moral hazard *and* contagion, preventing investors from taking huge losses on Greek debt, and ensuring political survival with support from domestic constituencies. Since these preferences require tradeoffs, Sarkozy and Merkel have both been likely to choose a middle ground between the two.

However, there are some notable differences between France and Germany. The first is that France errs on the side of preventing contagion, rather than preventing moral hazard. Part of this might be because French banks hold more Greek debt than investors from any other country. Figure 3 emphasizes this point. At the beginning of the crisis, France and Germany combined were exposed to over half of all Greek debt, but France alone held a plurality (Bank for International Settlements, 2011). Additionally, France has a weaker economy than Germany and some commentators speculate that it could be the next center of the euro crisis, after the “GIIPS” countries of Greece, Italy, Ireland, Portugal, and Spain. It is therefore conceivable that it would be in the French interest to establish a precedent for EU Member States to come to the aid of struggling countries, which could also help explain its continued support for helping Greece and preventing contagion relative to Germany.

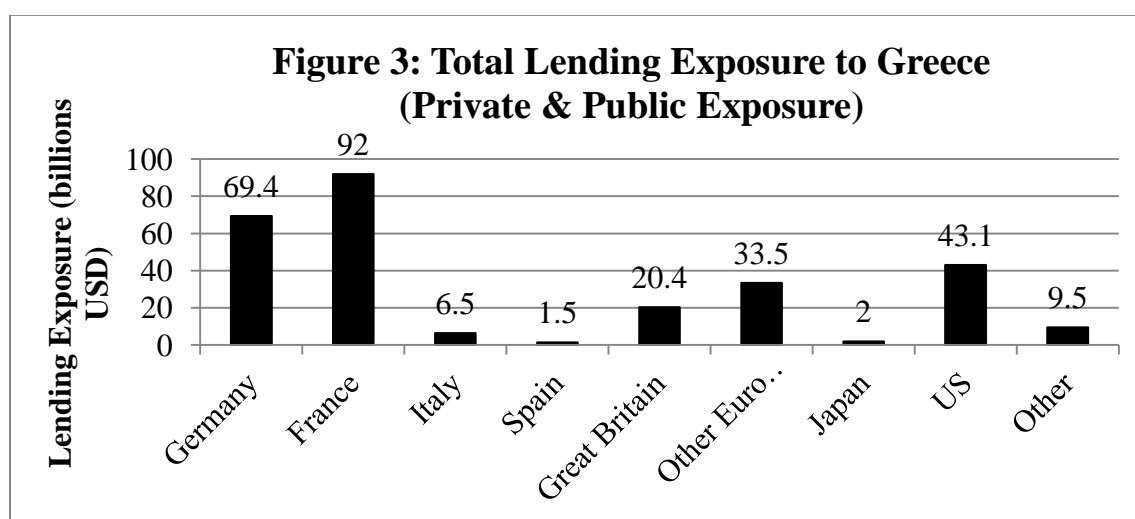


Figure 3. Source: BIS Quarterly Review, March 2011

President-elect François Hollande, elected on a platform that emphasizes making room for growth rather than enforcing austerity measures, will likely have a slightly different set of interests. His victory does not change my analysis of the policies that have already been adopted, but in the future, his plans will “be seen as a challenge to the German-dominated vision of economic austerity as a way out of the euro crisis” (Erlanger, 2012, A1).

### **EU Policies Regarding Greek Debt**

This section will highlight how European crisis management policies – specifically bailouts and austerity measures, private sector involvement, and bank recapitalization – have been the specific products of the competing international and domestic interests of German, French, and Greek leaders outlined above. Given the recurring preferences for preventing Greek default and protecting bondholders, preventing contagion, and preventing moral hazard, one might expect policy outcomes that combine “debt relief, emergency bailout funds, and buffering the crisis to prevent as much contagion as possible” (Caporaso & Kim, 2012, 24) with conditions for austerity.

The following section, in contrast with this one, will address what European leaders have done and will do to prevent future crises.

#### **Bailouts and Austerity Measures**

Bailouts conditioned on austerity measures reveal the compromises between the Greek preference to avoid default with a bailout, the French interest in saving Greece from default, and

the German preference – determined by domestic political constraints – to prevent moral hazard through spending cuts and the reorganization of Greek fiscal policies.

In early 2010, uncertainty in financial markets forced the Greek government to dramatically raise interest rates on government bonds due to a risk of insolvency. With no practical access to credit, and \$11.3 billion of debt scheduled to be paid on May 19, Greece was on the brink of default. On May 2, 2010, the EU together with the IMF agreed on a bailout deal wherein Greece would receive over €100 billion euro in loans (Caporaso & Kim, 2012). On May 9 of the same year, the European Financial Stability Fund (EFSF) was created as a temporary fund with a lending capacity of €440 billion. With limited success in its attempt prevent contagion to other countries in the euro area, its capital guarantee was be expanded to €780 billion in July 2011. These policy responses, which have not entailed changes to the Economic Monetary Union or the Lisbon Treaty, have been conditioned on austerity measures including public sector salary cuts, higher taxes on luxury items like alcohol and cigarettes, and stricter retirement rules (Bilefsky, 2010, A6).

The debates between bailouts (preventing contagion) and austerity (preventing moral hazard) point to one of two major fault lines in the euro crisis today: creditor and debtor states. These are roughly, but not explicitly, divided between northern and southern Europe. As a debtor state, Greece is at an economic disadvantage, which is why it has accepted German-imposed austerity. Unsurprisingly, Germany and France have granted the bailouts because of their own interests in preventing contagion and preventing losses to their investors

### **Private Sector Involvement and Bank Recapitalization**

The second fault line is between states and markets. This is critical because it further defines the debate over who will bear the losses of Greek debt. France and Germany have been reluctant to accept private sector involvement, choosing instead to protect their investors through bailouts.

However, Greek debt is simply too high for the Greek government to be able to pay back their investors, particularly given an economy with low productivity and a weak administrative capacity to collect taxes. As such, another package deal was adopted on October 26, 2011 that forced private investors to accept a fifty percent haircut on Greek bonds. It also made European banks raise €106 billion in new capital (Caporaso & Kim, 2012, 21). Similarly, in December 2011, the ECB announced a new plan to conduct longer-term refinancing operations (LTROs) in which it would guarantee full liquidity for European banks for three years at a one percent nominal interest rate (European Central Bank, 2011d).

Bank recapitalization is important insofar as it stopped, at least temporarily, the rising yield on bonds in Greece and other peripheral countries. It shows that European leaders interested in calming financial markets and limiting contagion can do so successfully if present bold and certain plans to show that they are serious about their work.

In conclusion, policy outcomes have focused on emergency bailouts, long-term debt restructuring, and buffering the crisis by ensuring bank liquidity. While these policies have not entirely prevented contagion *or* moral hazard, they have been an intentional mix between the two. However, European leaders also concern themselves with fixing institutional defects within the EMU to prevent future crises, rather than simply managing the current one in Greece.

### **Institutional Defects of the EMU & the Political Feasibility of Eurozone Reform**

This section will analyze how actors' interests will affect economic decisions not only as they relate to managing the Greek debt crisis, but also to preventing a future eurozone crisis. That necessitates a focus on the institutions of the Economic Monetary Union and a perspective than considers the crisis euro area more broadly than the Greek debt crisis specifically. This section will therefore analyze the political likeliness of three potential institutional changes of the eurozone that would, in various ways, prevent future crises: a total eurozone collapse, a Greek exit, and further integration. I predict that EU Member States will pursue further economic integration, but that reforms will be incremental, limited to what is necessary to respond to the euro's difficulties today.

#### **Total Eurozone Collapse**

A total collapse of the eurozone would prevent future crises insofar as there would be no eurozone to have a crisis. Future monetary, fiscal, and economic problems might be severe, but would be left to the states to resolve with currency, wage, or labor flexibility at their discretion. However, this option is highly unlikely for both economic and political reasons.

There is no doubt that the creation of the eurozone and the pursuit of eurozone membership entailed large fixed costs for all eurozone Member States. Historical institutionalism asserts that such sunk costs create a rational political unwillingness to disassemble already-made institutions, which "may lock in member states to policy options that they would not now choose to initiate" (Pierson, 1996, 144). As James Caporaso writes, the costs of dismantling the eurozone would be huge, not just in terms of "the efficiency losses associated with having to

change currencies in international transactions,” but also in “evaluating the value of property held by nationals of other countries, including the assets of multinational corporations, and the inevitable legal issues that would arise over who owns (and owes) whom what” (2012a, 24). The Union Banque de Suisse (UBS) estimates that a breakup of the eurozone could cost a peripheral country 40-50% of its GDP, while core countries might lose 20-25% GDP (as cited in Caporaso & Kim, 2012, 24). While political interests tend to weigh more heavily than economic interests in political decisions, this option is not in the interests of core or peripheral eurozone Member States.

Furthermore, actors within the institutions of the European Union can take advantage of their own political resources to maximize their own power, which can result in institutional security for the EU, even to the chagrin of Member States (Pierson, 1996). While the end of the eurozone is therefore unlikely, the danger for the EU is that its institutions “could gradually weaken into irrelevance... while real politics takes place elsewhere” (Garton, 2004, 196).

### **Greek Exit**

Short of a total eurozone collapse, Greece may choose or be forced to exit. Previously unthinkable, this institutional change has been considered increasingly in recent months. As “a sign of how far things have come, the once-taboo topic of Greece being forced to exit the euro has become so common in public discourse recently that there is not a shorthand term: ‘Grexit’” (Donadio & Kitsantonis, 2012).

From the perspective of Greek leaders, exiting the eurozone could be beneficial for two main reasons. First, re-creating the drachma would allow Greece control over its own monetary policy – i.e., the ability to devalue its currency. In the short term, that would make it easier for

Greece to pay back its debt, and exports would be more competitive. Second, with a devalued currency, Greece could avoid bailouts and the austerity measures on which they are conditioned. New Greek leaders, elected with a mandate to renegotiate austerity measures of the debt agreements, could conceivably decide to leave the eurozone altogether.

In this case, however, Greece would have little if any access to credit on bond markets or from the EU. In the long term, the benefits of currency devaluation are offset when workers demand increasingly higher wages. There would be political costs, too. As Barry Eichengreen writes, “A country that reneges on its euro commitments will antagonize its partners. It will not be welcomed at the table where other EU-related decisions are made. It will be treated as a second class member of the EU to the extent that it remains a member at all” (2010). Exiting the eurozone, therefore, does little to solve Greek’s debt problems; it merely takes those problems outside of the eurozone. Given those costs, and the fact that the three leading Greek political parties are pro-Europe even if they do not approve of austerity, it is unlikely that Greece will choose to exit the eurozone.

For other eurozone leaders as well, a Greek exit would solve few problems. French and German bondholders could face huge losses on their investments if Greece devalued its currency. Financial uncertainty could still cause contagion. Negotiating an orderly exit would entail some of the same costs associated with a total eurozone collapse. And Greece exiting the eurozone would not necessarily prevent future crises, since other peripheral countries would still cause concern about the lack of true economic integration.

A Greek exit would nearly or entirely prevent moral hazard, as all of the responsibility for Greece’s debt would lie with Greece. However, both a eurozone collapse and a Greek exit would continue financial uncertainty and exacerbate contagion. As far as domestic politics go,

Greek voters have sent clear messages in recent elections that they want to see increased growth, which exit would not bring. Debate about institutional defects in the eurozone is far from over, but early empirical evidence is consistent with my prediction that leaders will not attempt to prevent future crises by pursuing radical measures like breaking up all or part of the eurozone.

### **More Integration among Eurozone Members**

The more likely option, even given recent elections, continues to be fostering increased economic integration among the member states that are already part of the eurozone. As there is much more room for eurozone integration, there are a variety of ways that such integration could be achieved. The real question about the future of the eurozone, then, is what kind of integration this will be. This subsection contends that Europe will see incremental reforms to its existing institutions in direct response, rather than radical shifts to a federal system..

**European Treasury and fiscal federalism.** The most basic problem with the eurozone's institutions at the beginning of the crisis is that they achieved monetary convergence without fiscal or economic convergence. The simplest economic solution, then, is to create a true fiscal federation, with a European Treasury and centralized taxation powers. However, such a large step is highly unlikely to happen given the pattern of European integration. A quote from Jean Monnet, the veritable godfather of the European Union as it is known today, offers an insight to this: "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises."

Extreme reforms require changing the Treaty, and that requires the consent of twenty-seven Member States, each with different set of interests and a unique domestic political situation. While changing the Treaty is possible, federal reforms are unlikely to be successful. Of

particular importance is Germany, whose Constitutional Court approved the Lisbon Treaty only while reaffirming that the Union's "fundamental order is... subject to the disposal of the Member States alone and in which the peoples of the Member States, i.e. the citizens of the states, remain the subjects of democratic legitimisation" (Federal Constitutional Court, 2009). In other words, national identity "takes priority over integration," and "the recognized democratic deficits in the EU" require greater reforms to be resolved than "enhancing the rights of the European Parliament" with the Lisbon Treaty (Der Spiegel, 2009).

Future reforms, then, will be more like the functional ones Europe has seen in its path from the European Coal and Steel Community to the single market and euro area: gradual, with reforms geared to problem-solving and a focus on cooperation with the private sector. This brings up problems of governance, as the technocracy inherent in the system alienates voters and decision-making is difficult to do quickly when power is dispersed among 27 governments concerned with preserving their own sovereignty<sup>1</sup> (Economist, 2011c). Desperate times such as the present call for desperate measures, but only in response to those times (Laffan, 2012).

The reforms most likely to be adopted will be changes on the eurozone's existing institutional structure, rather than the creation of new structures altogether. Empirical evidence from the past several months already supports this hypothesis, so the rest of the section will discuss institutional reforms that the EU is likely to pursue or has begun to make: a permanent ESM, debt brakes in national constitutions, supranational banking policies, and an emphasis on growth.

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<sup>1</sup> It remains questionable how much Member States are concerned with sovereignty in and of itself. Paul Pierson summarized this best: "Under many circumstances, the first concern of national government is not with sovereignty per se but with creating the conditions for continued domestic political success" (1996, 136). This is a more nuanced approach; the more Member State governments are held responsible to national publics – rather than an institution like a European Treasury – the more Member States will be interested in retaining their sovereignty.

**Permanent European Stability Mechanism.** The first example from this evidence is the creation of the European Stability Mechanism (ESM) in March 2011, a “permanent bailout mechanism with a lending capacity of 500 billion [euros]” that in February 2012 would also incorporate the funds from the EFSF (Caporaso & Kim, 2012, 20). Granted, the ESM could be considered a policy (crisis management method) rather than an institutional reform (crisis prevention method), but the fact that it is now a permanent structure in the Treaty pending approval from national parliaments makes it an example of an institutional reform rather than simply a policy adopted to manage Greek debt.

This is important because, as noted previously, markets responded negatively not to the announcement of massive Greek debt, but to the uncertainty caused when Germany and Merkel hesitated to provide the bailout funds that would prevent Greece from defaulting. As such, economic integration to the extent that the EU provides a credible commitment to bail out Member States in the event that another crisis happens – much like markets expected in the years preceding the Greek debt crisis – would calm markets at present and help to prevent another crisis from happening in the future.

**Deficit and debt brakes.** Similarly, European leaders want to increase economic convergence so that Member States become less likely to need bailouts at the expense of taxpayers in countries like Germany. Some attempts have been made thus far to do so. Leaders of the eurozone countries agreed on December 9, 2011 to submit to more EU control over national budgets in an amendment to the SGP. The Six Pack, as the agreement is called, combines new regulations on debts and deficits with a stronger corrective arm than was in the SGP (Caporaso & Kim, 2012, 21-22). It will also be necessary, and “desired by some (particularly Germany)... that these rules have teeth” and not be undermined as the original SGP

was (Caporaso & Kim, 2012, 25). It is therefore likely that Member States will *want* to transfer supervisory power to European institutions to “insulate themselves from the everyday pressures to give in to exceptions and the desire to please special constituencies” (Caporaso & Kim, 25-26).

Additionally, the European Council in December 2011 decided on a fiscal compact for 25 of the 27 Member States. (Britain and the Czech Republic opted out.) The compact includes a new policy of “debt brakes,” which dictates that annual structural deficits may not exceed .5% of nominal GDP. This measure “complements an array of other provisions that aim to prevent the emergence of large fiscal deficits and strengthens the sanctions for rule violations” (Henning & Kessler, 2012, 2). The European Council also agreed that the reform would come in to play after only 12 Member States ratified the change, which has implications for the way the EU makes decisions in times of crisis and the way that it deals with countries that refuse to sign on to treaties (Laffan, 2012).

Debt brakes and the 2011 fiscal compact (formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) are important steps toward fiscal convergence as they mandate that Member States must have roughly similar fiscal policies. However, it is also important to note that the adoption of debt brakes requires national support as well as supranational support to be successful, and “the current adoption of ‘debt brakes’ in the euro area is driven more by the most dominant member states and the euro area institutions” (Henning & Kessler, 2012, 10-11). Additionally, as shown by the original SGP, when one state violates the rule, “its applicability to other states is less credible. That is less likely to be the case with rules that have been adopted autonomously” (Henning & Kessler, 2012, 19).

**Banking policies.** As the Greek sovereign debt crisis stemmed directly from the 2008 banking crisis, there is a near consensus among observers of the European situation that the European financial system needs banking regulations at the European level in addition to individual national levels. As Sapir, Ferry, and Darvas state, “Nothing less than supranational banking supervision and resolution bodies can handle the kind of financial interdependence that now exists in Europe” (2011, 6). Furthermore, it is incumbent upon the European Union to implement sufficient oversight to prevent borrowers like Greece from creating exorbitant levels of debt.

National leaders are likely to support supranational banking regulations because its benefits, in terms of ensuring continuity of policies across national borders and preventing a crisis like the Greek debt crisis, outweigh what costs it may have on national sovereignty. If voters disapprove of granting bank regulatory power to the EU, it is difficult to imagine that such a policy would be so controversial that it would mean certain failure during election season for leaders like Chancellor Merkel.

**Fostering growth.** More broadly, Greece and other peripheral countries need to become more economically competitive at the same time that they reduce their debts and deficits. While the fiscal policies of such countries in the years leading up to the 2008 financial crisis and the 2010 Greek debt crisis were fundamentally at odds with euro participation, the European Union can help encourage growth by fostering domestic policy reforms to temporarily lower living standards while increasing employment and productivity levels, particularly in the tradable sector so that Greece can increase its exports. Even if these domestic reforms are successful, though, they will take time to produce results (Sapir, et al., 2011).

In the meantime, structural funds should be reallocated “for the duration of the IMF/EU assistance programme. Spending priorities for this fund should be set to match the economic objectives of the programme, with a focus on growth and competitiveness” (Sapir et al., 2011, 1). The implications here of the Greek narrative discussed earlier are profound. For peripheral countries like Greece to become more economically competitive by increasing net exports, including to other European states, then core countries like Germany must necessarily *decrease* net exports, at least to its peripheral European neighbors. If economic convergence requires Greece to lower nominal wages, then Germany may also raise them, again diminishing its economic advantage. While these policies would be economically sound, they may not be politically justifiable.

However, recent and upcoming national elections may have an impact in this area. Just as the Greek public has neared a boiling point on austerity measures, sending a clear mandate to Greek leaders to renegotiate the debt agreement, Merkel has begun to look towards a difficult re-election in late 2013. France, meanwhile, elected François Hollande on a promise to promote growth. It is as of yet unclear whether this emphasis refers specifically to *national* growth or to growth for the whole of the eurozone. While these new leaders will still face many of the same resources and constraints as their predecessors, electoral changes may give new national leaders space to adopt growth-oriented policies in the periphery instead of focusing on austerity measures alone.

In conclusion, I argue that the European Union is most likely to attempt to prevent future crises by continuing along a path to increased integration rather than allowing the eurozone to collapse or force Greece to leave. However, the reforms which have already begun will alter

existing institutions by creating a permanent bailout mechanism, placing limits on debts and deficits, and reforming banking policies, rather than making the leap to a fiscal federation.

### **Conclusion**

The Greek sovereign debt crisis is one of the most-debated issues in contemporary European politics. It was caused not by inadequate economic institutions, but by the insufficient application of the convergence criteria to Greece, the disintegration of the Stability and Growth Pact, and the resulting perverse incentives of French and German banks to lend irresponsible amounts of money to Greece. The EU's policies so far – loans for Greece, reducing debt, and ensuring bank liquidity – have been helpful but not altogether sufficient. Broader institutional reforms must also be made. The European Union must reform the European banking system, calm financial panic through economic convergence and preventing excessive debts and deficits, and encourage growth in Greece and other peripheral countries. Of these, Member States have already started to aim for the economic convergence that should have been upheld at the EMU's founding. However, other long-term institutional reforms such as encouraging Greek growth provide fewer short-term benefits to political leaders outside of Greece.

Recent elections in Greece and France reframe the eurozone's problems as a lack of growth-inducing policies rather than a lack of fiscal responsibility in the periphery. It is therefore possible – though at this point not probable – that newly-elected European leaders will exhibit solidarity with Greece without additional political incentives to do so that they currently have.

Aside from institutional reforms to promote growth, most things in European politics can be expected to stay the same after these elections. Voters are constant, even if their opinions are

not, as national leaders must respond to their domestic constituencies to ensure political survival. French and German holders of Greek debt are constant. In short, the institutional situations of national leaders remain constant, which means that even different actors in the same offices will continue to be motivated by many of the same preferences, resources and constraints.

This suggests that the EU's institutions also need strong political leadership and the support of national publics, two things that the EU lacks but that are immensely important in a modern democracy. Timothy Garton Ash phrased this well when he wrote that for the European Union to continue to be a relevant political institution, it requires not just the support of France and Germany, but that "political pilots in a sufficient number of member states need to agree on a strategic direction for the Union, suggest the way forward to their colleagues in the E.U., and secure the assent of their own peoples" (Garton, 2004, 195).

Future research may be directed towards determining the best institutions to secure this domestic assent, be it through economic well-being, civic institutions, or a pan-European identity or *demos*. Fundamentally, it is clear that if European leaders are to resolve economic troubles like the Greek debt crisis and continue to promote economic integration – and it is not absolutely necessary that they will or that they should – then they need the support of national publics for the policies of European integration.

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