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Eastern Europe and the Fiscal Crisis in the Eurozone

European leaders must act fast to contain the Greek crisis.

—Angela Merkel, May 7, 2010

The crisis resolution in Eastern Europe was close to ideal with its simple and clear logic. After two years of intensive care, these countries, the International Monetary Fund (IMF), and the European Commission could declare victory. But in the first half of 2010 a new financial crisis erupted in the eurozone, with multiple implications for Eastern Europe and its standing in the European Union.

The European Union is not a club of equals. Having expanded gradually, it is a two-tier club with old insiders roughly corresponding to the membership of the Economic and Monetary Union (EMU) and new outsiders, primarily Eastern Europe.[1] Especially France and Germany have repeatedly spoken about the need for a "two-speed" Europe, suggesting that the original six members of the European Union would integrate faster.[2] Ironically, the three big old members, France, Germany, and Italy, have stood out by doing the least reform, while Eastern Europe and the Nordic countries have done the most.

Instead, the EU core, whose exact composition has varied, has expropriated privileges for itself, not least in fiscal policy. EU fiscal policy is supposed to be ruled by the Maastricht criteria or the Stability and Growth Pact (SGP). But many countries grossly violated the Maastricht criteria on budget deficit and public debt (chapter 1). The original sin of the EMU was that both Belgium and Italy had entered with far too high public debt levels at the end of 1998, 117 and 115 percent of GDP, respectively, while

1. Of course, the United Kingdom, Denmark, and Sweden are not members of the eurozone, while Slovenia and Slovakia are.

2. They are France, Germany, Italy, Belgium, Netherlands, and Luxembourg.

the Greek debt was "only" 95 percent of GDP. Germany was just over the 60 percent ceiling and France just below. In 1998, Portugal, Spain, and Greece violated the budget ceiling of 3 percent of GDP. Germany exceeded the budget ceiling for the four years from 2002 to 2005 and France for three years. At the end of 2009, the average public debt of the EMU countries was a shocking 79 percent of GDP, and 10 of the 16 EMU countries but only two of the non-EMU countries (Hungary and the United Kingdom) exceeded the public debt ceiling.[3] Germany fulfilled the debt criterion only in 2000 and 2001, while France has not done so since 2002.

Most spectacular, in November 2003, Germany and France relinquished the little fiscal discipline that existed by jointly aborting the SGP, because they neglected to fulfill its criteria, but even so the ECOFIN Council (of the EU ministers of finance) decided to put the excessive deficit procedures for France and Germany on hold. The SGP was revised, so that a deficit above 3 percent of GDP was not necessarily considered excessive if it could be shown that the breach was "exceptional and temporary."[4] Since France and Germany openly jeopardized the SGP and received no penalty, it lost all credibility within the EMU, preparing the road to the current crisis. The problem was not the Maastricht criteria, which made a lot of sense, but the lack of implementation in the EMU.[5] As the *Economist* put it: "France and Germany led a rebellion against the disciplines of the 'stability and growth pact' on the first occasion it looked about to catch them. That signaled a free-for-all."[6] Fiscal standards were a joke within the EMU but they were taken seriously by EU members outside of the EMU.

When the financial crisis first hit, the eurozone countries also considered themselves immune to the IMF and its bailouts. However, when the crisis started to bite, they realized that they had to accept the same rules as others. The eurozone's fiscal crisis was far worse than the East European crisis, which was primarily a current account crisis. When the eurozone approached its crisis, the east had largely resolved its crisis and could inform the eurozone countries what to do. The eurozone crisis leveled Western Europe with Eastern Europe. The convergence of rules brought the new EU members closer to the old euro core, and institutions for the

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3. The six virtuous countries were Cyprus, Finland, Luxembourg, Slovakia, Slovenia, and Spain—that is, three (Cyprus, Slovakia, and Slovenia) were recent additions, and only Spain was a large country.

4. José Manuel González-Páramo, "The Reform of the Stability and Growth Pact: An Assessment" (speech, conference on New Perspectives on Fiscal Sustainability, Frankfurt, October 13, 2005), available at www.ecb.int (accessed on May 15, 2010).

5. Jean Pisani-Ferry, "Euro-Area Governance: What Went Wrong? How to Repair It?" Bruegel Policy Contribution, Issue 2010/05 (Brussels: Bruegel, June 2010).

6. "Staring into the Abyss," *Economist*, July 10, 2010, 24.

European Union as a whole are likely to be strengthened. Yet as the eurozone accounts for most of Eastern Europe's exports, its crisis will slow down its recovery.

The Greek Tragedy

Greece was the worst fiscal sinner, having never complied with the Maastricht criteria. It joined the EMU in 2001, two years after the latter's creation. It violated the Maastricht rules persistently and blatantly. Spectacularly, Greece maintained an average budget deficit of 7.3 percent of GDP from 1990 to 2009, with a public debt never less than 94 percent of GDP. Its government was revealed to have repeatedly fudged its budget deficit.

Even so, Greece was never penalized. On the contrary, it was a major beneficiary of EU structural funds and farm subsidies, amounting to several percent of its GDP every year. Thanks to its membership in the EMU, Greece enjoyed almost as low yields as Germany on its treasury bills. Even so its production costs rose so that it became uncompetitive with a persistent large current account deficit and probably the least free economy within the European Union.

In early 2010, Southern Europe, or the so-called PIGS (Portugal, Italy, Greece, and Spain), was heading toward a serious fiscal crisis, with Greece in the lead. Greece's corrected budget deficit was 13.6 percent of GDP in 2009 and its public debt 115 percent of GDP. These revelations came in October 2009 after a newly elected socialist government under George Papandreou was sworn in. A first disclosure of the much larger budget deficit unleashed the crisis, and a second downward revision of the budget deficit in April 2010 eliminated all market confidence.

Rather than repeating the successful EU cooperation with the IMF in Eastern Europe, the EMU governments delayed crisis treatment, pursuing haphazard improvisations from February until May 2010, when financial markets exploded. The actors were the eurozone countries and the European Central Bank (ECB) rather than the European Union as a whole. Their policy line made little sense.

First, the other eurozone governments told Greece not to go to the IMF, denying it adequate professional and financial assistance. The Greek government listened to its EMU peers, even though their position had no legal basis. Michael Burda argued: "I doubt Europe could stomach giving away real authority on fiscal matters to a third party, especially given the dominant role of the US" in the IMF.[7] The rest of the world on the contrary complains that the IMF is excessively dominated by Europe-

7. Michael Burda, "Greece: It's Not All Tragedy," www.voxeu.org, March 13, 2010.

ans.[8] The IMF managing director has always been European (Frenchman Dominique Strauss-Kahn at the time) and the director for the European region was also European. The eurozone countries inevitably took on greater financial costs both by delaying action and by holding Greece away from the IMF. Moreover, the IMF is primarily financial and technocratic, which facilitates its role as crisis manager, whereas the European Union and the European governments are profoundly political, often making it more difficult for them to take principled decisions. Because the eurozone countries tried to take the lead, a vicious public dispute arose between Germany and Greece, which complicated the resolution of the Greek crisis.

Second, the eurozone countries denied Greece the right to an emergency loan, which all IMF members enjoy. The formal excuse was that Greece as a member of the EMU was supervised by the ECB. Article 125 of the Treaty on the Functioning of the European Union stipulates that neither the Union nor any member state could assume financial commitments of any other member state, prohibiting the European Commission and the ECB from providing financial support to a member state in financial hardship.[9] But accidents happen and each financial community needs adequate tools to handle them. This clause made the EMU dysfunctional and threatened its survival. Wolfgang Münchau commented: "Article 125 of the Lisbon treaty is the kind of law that is irrelevant until needed, at which point it becomes impossible to apply."[10]

Third, after leading Greece and themselves into a financial abyss by jeopardizing the SGP, the eurozone governments insisted on playing a guiding role in Greece, for which they had few qualifications and no institutions. The only justifications were really pride and privilege. German Finance Minister Wolfgang Schäuble endorsed a proposal to develop a European Monetary Fund,[11] but it was soon discarded.

Fourth, the European Union refused to deal with the cause of the financial crisis: fiscal malfunctioning of member governments. It avoided the topic of restoring the SGP. Instead, EU politicians were preoccupied with minor matters, such as the possible regulation of hedge funds,

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8. My colleague Arvind Subramanian calls it the Euro-Atlantic Monetary Fund.

9. Treaty on the Functioning of the European Union, *Official Journal of the European Union*, Information and Notices C 115, volume 51, May 9, 2008, available at http://eur-lex.europa.eu.

10. Wolfgang Münchau, "Germany Pays for Merkel's Miscalculations," *Financial Times*, May 11, 2010.

11. "Schäuble liebäugelt mit einem EU-Währungsfonds [Schäuble Is Toying with an EU Monetary Fund]," *Die Welt am Sontag*, March 6, 2010; Daniel Gros and Thomas Mayer "Towards a Euro(pean) Monetary Fund," CEPS Policy Brief (Brussels: Centre for European Policy Studies, February 8, 2010)

private equity funds, and investment trusts through a new EU directive on alternative investment fund managers as well as the persecution of tax havens, and the German government restricted short-selling. None of these had contributed to the crisis. The Greek government responded by suggesting fiscal measures that were insufficient.

Münchau passed a harsh judgment: "Europe's leaders are not solving the problem, they are fighting a public relations war. Their target is not economic imbalances, but speculators: hedge funds, investment banks, bond market vigilantes and in particular, those ominous Anglo-Saxon rating agencies."[12] Similarly, some European leaders were preoccupied with "harmonization" of taxation and regulation, hindering structural reform. The main proponents of these arguments in spring 2010 were Germany, France, and the ECB.

However, the public and acrimonious debate as well as crisis in European financial markets helped to clear the thinking. Policymakers realized that their old positions were not viable. From May to July 2010, the same politicians were forced to reverse their thinking on all the key issues, and EU economic policy changed more than in the last decade since the launch of the euro, as often happens in financial crises.

The Greek Rescue Package of May 2, 2010

Finally, on May 2, 2010, the IMF was admitted to the center stage, as the ECB and the eurozone governments permitted the Greek government to call in the IMF as the agent of financial stabilization. The IMF and the European Union made an agreement with the Greek government on a standard IMF standby program for three years.

The Greek rulers became serious about fiscal policy. Substantial budget cuts were finally made. A first Greek stabilization program in March reduced the budget deficit by 4 percent of GDP in 2010. The IMF-EU standby program of May 2 demanded substantial additional spending cuts, raising the total cuts to 7.5 percent of GDP in 2010.

The no-bailout clause was circumvented. A stabilization program must be sufficiently financed, and the funding was unprecedented: credits of $145 billion (€110 billion), of which €80 billion from EU countries and €30 billion from the IMF, but nothing from any EU institution. Latvia's stabilization package, one-third of its GDP, would correspond to $100 billion for Greece, but since Greece's crisis was more severe, more funding was required. The IMF package corresponded to 32 times the Greek IMF quota, and the eurozone package for Greece to 0.9 percent of

12. Wolfgang Münchau, "The Eurozone Must Take Responsibility or It Will Split," *Financial Times*, May 10, 2010.

the eurozone's GDP. Since the eurozone countries had excluded everybody, they received neither sympathy nor financing, which was the price of their privilege.[13]

The question remained whether the Greek public debt of 115 percent of GDP or $400 billion was sustainable or needed to be restructured. The IMF program aimed to stabilize it at 140 percent of GDP in 2014, but with output likely to contract more than the IMF assumed, debt could easily rise above 150 percent of GDP. Greece was really an emerging market. Kenneth Rogoff noted "that most emerging markets run into trouble at external debt levels of merely 60 per cent of GDP" and "that a country can repay its debt does not necessarily mean it should choose to do so."[14] Barry Eichengreen put it in the affirmative: "Greece will restructure its debt… the only controversy is why a restructuring was not part of the initial IMF-EU rescue package."[15] As Rogoff and Carmen Reinhart have shown in their excellent history of financial crises, *This Time Is Different*, virtually all countries have at some time defaulted on their debt, even if they also argue that developed economies have graduated from defaults.[16]

Still Greece had no reason to abandon the euro. Not only would it lose its claim to European funding but also its departure from the euro would probably lead to a big depreciation, which could double its public debt in relation to its GDP, as the debt would be denominated in the then foreign currency, euro. Greece would default instantly on both public and most private debt, which would lead to total financial chaos.[17]

In effect, Greece was following the lead of the Baltic "internal devaluation," cutting public expenditures, wages, and pension obligations, while pursuing domestic structural reforms to reduce costs. The Baltic governments had shown the way by successfully insisting on the peg with strong popular support. A fixed exchange rate forces a country to reduce costs and undertake structural reform. This crisis can render Greece a freer and more competitive economy.

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13. Slovakia, which had adopted the euro on January 1, 2009, changed government in June, and its new government refused to contribute.

14. Kenneth Rogoff, "Europe Finds that the Old Rules Still Apply," *Financial Times*, May 10, 2010.

15. Barry Eichengreen, "It Is Not Too Late for Europe," www.voxeu.org, May 7, 2010.

16. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).

17. Marek Dabrowski, "Euro Crisis or Debt Crisis?" CASE Network E-briefs 9/2010 (Warsaw: Centre for Social and Economic Research, June 2010), www.case-research.eu.

The South European Rescue Package, May 9–10, 2010

The Greek rescue package was not sufficient to halt the spreading financial panic in Europe. Over the following week, fear of contagion spread to Portugal and Spain, as their bond yields rose and stock prices around the world plummeted. People spoke about a possible second Lehman Brothers shock.

The South European financial crisis illuminated the problem with both the European Union and the EMU: Europe is a halfway house. The long-awaited Lisbon Treaty had just come into force. It was being tested, and it was failing. The European Union had not obtained any more effective leadership or governance. Europe faced a clear-cut choice: to integrate with functioning fiscal policy coordination or to disintegrate.[18]

The cause of the Greek and South European financial crisis was not the Maastricht criteria but that they have never been imposed. The idea of a common European fiscal regime had hardly failed. On the contrary, the crisis showed how badly it was needed. The Scandinavian countries, the Netherlands, and Luxembourg had done well by sticking to the Maastricht criteria. So did the four EU currency board countries. The European Union's problem was its inability to discipline the core, the EMU, especially Germany and France, not the periphery, where new eastern EU members faced hard budget constraints and were forced to behave better than the core. By contrast, the privileged treatment of the PIGS, Belgium, France, and Germany had caused their severe public finance problems. Now, they were receiving the bill for their lack of fiscal discipline.

What a difference a week can make! After week-long financial panic, the EU ministers of finance held an extraordinary Council night session on May 9–10, making most of the necessary decisions.[19] This time it was the whole European Union, not just the EMU group.

Substantial financing was vital, and the European Union and the IMF put up nearly $1 trillion, consisting of €500 billion of EU funding and €250 billion of IMF funding.[20] The EU funding would consist of two parts. The bulk of €440 billion would be contributed by the EMU member states to a special purpose vehicle, to which Sweden and Poland volunteered to contribute as well. It was to be named the European Financial Stability Facility, designed as a temporary new EU institution. The remaining €60 billion would be added to the existing €50 billion balance-of-payments support fund, which had previously been reserved for non-eurozone EU

18. Wolfgang Münchau, "Europe's Choice Is to Integrate or Disintegrate," *Financial Times*, May 3, 2010.

19. Council of the European Union, "Extraordinary Council Meeting, Economic and Financial Affairs," press release 9/10, Brussels, May 2010.

20. Ibid.

members, and €14.6 billion had been committed to Hungary, Latvia, and Romania. It would be financed by all EU members. This complied with the first rule of financial crisis management, established by Walter Bagehot in *Lombard Street* (1873), that in a crisis loans should be granted to all comers on the basis of sound collateral "as largely as the public asks for them."[21]

Another improvement was the EU decision to accept bailouts. The European Council lifted its eyes to Article 122.2 in the Treaty of the Functioning of the European Union, which in no uncertain terms allowed bailouts:

> Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or *exceptional occurrences beyond its control*, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned [my emphasis].[22]

In order to enhance its credibility, the European Union once again invoked the authority of the IMF. The European Union also committed itself to strict fiscal policies and insisted on Portugal and Spain reducing their dangerously large public deficits. The ECB was allowed to carry out direct purchases of eurozone public and private debt to activate and restore frozen financial markets, as the US Federal Reserve had done from the fall of 2008. The European Union also activated a dollar swap line with the US Federal Reserve that had been agreed in the fall of 2008 but was allowed to lapse after that first rampant crisis was over.

Suddenly, the European Union had decided most of the necessary actions to resolve the financial crisis. The big outstanding questions were whether debt restructuring was necessary and how to police fiscal policy in the future.

East European Lessons Dawn on the Eurozone

The European Union suddenly found itself drawing lessons from what the East Europeans had done since the onset of the crisis in 2008. The central conclusion, as formulated by Martin Wolf, was: "As initially designed, the EMU has failed. It will succeed only if radically reformed."[23] The European Union and the ECB started doing just that.

First, the eurozone countries let the IMF lead in financial stabilization

21. Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes*, 5th ed. (Hoboken, NJ: Wiley, 2005), 237.

22. Treaty on the Functioning of the European Union, *Official Journal of the European Union*, Information and Notices C 115, volume 51, May 9, 2008, available at http://eur-lex.europa.eu.

23. Martin Wolf, "Governments Up the Stakes in Their Fight with Markets," *Financial Times*, May 12, 2010.

and abandoned their prior ideas of the EMU's superiority and exceptionalism after the opposite had become evident. The IMF had the relevant competence and more credibility in handling financial emergencies than the ECB, the eurozone finance ministers, or the European Commission.

Second, the eurozone countries accepted once again that the fiscal discipline of the SGP was vital and that radical fiscal adjustment was possible and necessary. The corollary was that eurozone countries, such as Greece, were no longer so privileged that they could disregard EU rules. How the European Union is to impose fiscal discipline remains unclear, but during the crisis the bond market started enforcing the rules, by differentiating sharply between eurozone countries' bonds and punishing the fiscally weak countries with high bond yields.

Third, the eurozone abandoned the illogical no-bailout clause. A monetary union cannot survive severe financial crises without a fiscal rescue facility. Staring into the financial abyss, EU leaders recognized that they needed such facilities and made them sufficiently large. Essentially, the European Union decided to combine the monetary union with credible fiscal discipline and fiscal rescue funding. The distinction between first- and second-class members was blurred, and the European Union has become more equal. The ECB agreed to buy bonds and thus start participating in quantitative easing. Most of the bonds it bought were Greek government bonds.

The United States reengaged. It had minimized top-level engagement in the East European financial crisis and the South European financial crisis until the weekend of May 7–9, when top US policymakers engaged directly because they feared contagion to the United States and the rest of the world. Two major US tenets were that the financing had to be huge and the fiscal cuts credible. The United States accepted the sizable IMF intervention but did not offer bilateral assistance, though the US Federal Reserve revived swap credits to the ECB to make sure that it had sufficient dollar liquidity.[24]

The May 9–10 rescue operation was sufficient to stop financial panic and hinder contagion from the Greek crisis to Portugal and Spain. The Greek rescue package was so large that the country does not need to sell any bonds for about two years. The Greek debt service may not be sustainable, and a missing piece in the new European financial architecture is a system for sovereign debt restructuring within the EMU. Admittedly, debt restructuring is usually carried out ad hoc, but the European Union may benefit from an insolvency facility. It could be built on the new, but so far temporary, European Financial Stability Facility, which could become a European Monetary Fund, in the sense that it would be a fund for emergency bailouts of sovereign debt.

24. James Politi, "Fear of Contagion Drove US to Push for Action," *Financial Times*, May 11, 2010.

Following the example of the United States in May 2009, the European Union decided to carry out a bank stress test to quell worries about lacking transparency and insufficient capital in the banking system. The US stress test involved only 19 banks and the EU test 91 banks, but each covered 65 percent of the region's banking assets. The difference in the number of banks reflects the great concentration of the US banking system. The European stress test covered no fewer than 27 Spanish banks and 14 German banks but no more than six from the other EU countries, because Spain and Germany were the countries where the greatest problems were likely.[25] The result was published on July 23, 2010. The test did attain great transparency but appeared softer than the American one, and only seven small banks were considered to have too little capital. The required capital injection was only $4.5 billion compared with $75 billion in the US stress test.

An important consequence of the European bank stress test will be to bring the European Union closer together. Before the crisis, bank inspection had been strictly national, but the stress test was carried out by the EU Committee of European Banking Supervisors, which is a loose and newly formed institution pertaining to the European Commission. It applied to the EU-27 and was not reserved for the EMU of 16. The Committee of European Banking Supervisors was reinforced by the stress test and will soon become the European Banking Authority, an all-EU banking inspector, which was missing before the crisis but is now finally being set up. In parallel, similar all-European inspections for insurance and security markets are also being formed.

To most Europeans in the east and west, the euro remains attractive. If the euro had not existed, the European Union would probably have repeated its experience of competitive and disruptive devaluations of 1992, which gave the impetus to introduce the euro. Peter Sutherland formulates it starkly: "Without the single currency, Europe would be an economic wasteland. The cost of not having the euro would have been far greater over the past two years…. Competitive devaluations of national currencies after the financial crisis of 2008 would have led to economic chaos incomparably worse than the turbulence we are now experiencing."[26] The problem was not the euro per se but the inadequate governance structure. The smaller and more open an economy, the greater its inclination to peg to and eventually adopt the euro.

Through adequate U-turns, the European Union sorted out most of its financial policy problems in the second quarter of 2010. It allowed the IMF to take the lead in financial restoration also within the EMU. The

25. Committee of European Banking Supervisors, "CEBS's Statement on Key Features of the Extended EU-wide Stress Test," July 7, 2010, available at www.c-ebs.org (accessed on July 21, 2010).

26. Peter Sutherland, "Radical Reforms Can Save the Euro," *Financial Times*, June 30, 2010.

eurozone countries invited the rest of the European Union to commiserate about their financial problems. The SGP has been restored, and the bond market is likely to enforce it in the future. Together with the IMF, the European Union has succeeded in mobilizing sufficient bailout funds, and the European Union has time to contemplate what to do about sovereign insolvency.

For Eastern Europe, the EMU crisis in the spring of 2010 meant convergence with the EMU. The SGP applied not only to Eastern Europe but also to the eurozone. The IMF and the European Commission were now playing the same role for supervision of and emergency financing to both areas. To become more competitive eurozone countries were forced to carry out the structural reforms that the East Europeans had already undertaken in their internal devaluations. Eastern Europe is making its mark on the European Union with its lower public expenditures and taxes. In recent years, the European Union has seen personal income tax rates and corporate profit tax rates plummet because of tax competition from the east. In the regulatory sphere as well, competition is bringing down barriers, for example, in labor markets. The new EU-wide supervision of banks, security markets, and insurance offers new financial safeguards common to all EU members. The East Europeans have emerged as the successful pioneers of a new, more liberal, and fiscally responsible all-European economic system.