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Kicking the can down the road
The political economy of Europe's sovereign debt crisis, 2010-2011

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Introduction

This paper will focus on the European Sovereign Debt Crisis from the perspectives of four critical actors (the European Commission, European Central Bank, France, and Germany), starting at the beginning stages of the crisis through to the Fiscal Pact of December 2011. We will look at the actors' respective positions at critical points of the crisis through excerpts from news articles, describing the outcomes that sprang from addressing the crisis as it developed. Through this study, this paper will also show how the various mechanisms to combat the crisis (the European Financial Stabilization Mechanism, European Financial Stability Facility, and European Stability Mechanism) have represented points of contention between the different Euro zone countries.

In looking to protect their interests, the actors have solidified or changed their stances at different points during the crisis. This paper will commence with a short look at the respective interests and power base of each of the four actors. Thereafter, four crisis points will be examined in turn: the first Greek bailout (May 2010), the imminent Portuguese and Irish bailouts (May 2011), the necessity for a second Greek bailout along with the unsustainable Italian bond yield rates (October 2011) and the Greek Referendum (December 2011).

The actors: positions, interests and power bases

The main actors have derived their positions at each stage from protecting their own interests and reinforcing them with their power base.

Technical legitimacy is the power base of the **European Commission (COM)**. The principle it defends is that of Europeanism, on one hand, and, on the other, the supremacy

of politics over economic and monetary purism. That is: that in the face of the troubles encountered by Greece, a political intervention is necessary - despite the fact that the Greek difficulties are consequences of economic mismanagement.

The **European Central Bank (ECB)** is the legitimate institution that determines the monetary policy of the EU. The ECB's primary aim is to maintain financial stability in the EU. It is politically independent and its area of work spans the interdependence of monetary and economic policy.

France's power base is its capacity as a lender or guarantor of European financial aid to Greece, as well as its large voting power in the Council. The basic principle it supports is similar to COM: the supremacy of politics over economic and monetary purism. Its interests are the well-being of France - threatened by the instability caused by the euro crisis - and the reelection of its President.

Germany, the economic engine of the EU and cornerstone of euro, has strong voting power and would be the main contributor to a possible rescue fund. Its interests are ultimately German well-being, and the reelection of its Chancellor. The principles it defends are the political independence of the ECB, economic and monetary discipline, and the consequentiality of one's actions.

Prologue

In late 2009, a new socialist Greek government, elected in October of that year, massively revises the Greek budget deficit for 2009 – accusing the previous Government of trying to cover up the extent of its deficit. The revision increases the deficit forecast from 6-8% (estimated by the previous government) to 12.7%. The Greek sovereign debt crisis is unleashed.

Context – February-April 2010 – Greece

After instituting austerity measures, Greek Prime Minister George Papandreou insists that Greece does not need a bailout. Greek bond yields skyrocket as the deficit is revised to 13.6% of GDP from the previously thought 12.7%. In April, after the financial markets take a turn for the worse, Euro zone countries discuss providing Greece with 30 billion euros in emergency loans.

The **European Commission** calls for intervention by the Euro group and wants to avoid IMF Involvement.

> "European Union officials are exploring the possibility of providing a heavily-conditioned loan to Greece instead of seeing it turn to the International Monetary Fund.
>
> Speaking after a meeting in Paris on 14 January with France's President Nicolas Sarkozy, Jean Claude Juncker, president of the Euro group said: "We do not think that assistance from the IMF to Greece would be appropriate or welcome."
>
> - European Voice – "EU Explores loan to Greece" – January 21, 2010

France wants to avoid IMF involvement.

> "When French President Nicolas Sarkozy put forward Strauss-Kahn's name to run the IMF, he meant to park a past and potentially future rival in a faraway place about which people cared little. Then the global financial crisis hit, and Strauss-Kahn was propelled to centre-stage.
>
> With France's next presidential election fast approaching in 2012, the last thing Sarkozy now needs is for Strauss-Kahn to play a statesman-like role in saving the eurozone."
>
> - European Voice – "Will Greece go to the IMF" – February 22, 2010

The **ECB** wants the capacity to buy bonds and access to a bigger budget.

> "Common and co-ordinated progress to create a European public bond market, after the remarkable performance of the European Central Bank in September-October 2008, would signal a strong Europe that has innovative financial instruments beyond the common currency. At the height of the financial crisis in September 2008, Jean-Claude Trichet, the president of the European Central Bank (ECB), exclaimed that there were limits to what the ECB could achieve for lack of conventional budget and debt instruments. A Europe where the weaker members of the Euro zone run first to powerful outside creditors for help only demonstrates the ECB's weakness."
>
> - European Voice – "Has the EU escaped a Chinese rescue?" – February 17, 2010

Germany wants to avoid EU involvement.

> "Germany wants discretion about any financial aid for Greece.
>
> Germany is resisting any announcement of a financial assistance package for Greece at the EU summit meeting in Brussels on 25-26 March. France and Belgium are leading the calls for EU leaders to shore up confidence in the Euro zone by some promise of support.
>
> Germany is backed by the Dutch and Austrian governments in arguing for discretion. Only if the Greek government fails to refinance its debt and is obliged to seek assistance from Euro zone members should any announcement be made, they say."
>
> - European Voice – "Division over Greek support at EU summit" – March 18, 2010

> "Germany is struggling to quell accusations that it has made the crisis worse by delaying triggering the package until after a regional election in North Rhine-Westphalia, Germany's largest federal state, on 9 May."
>
> - European Voice – "EU leaders struggle to contain eurozone crisis" – April 29, 2010

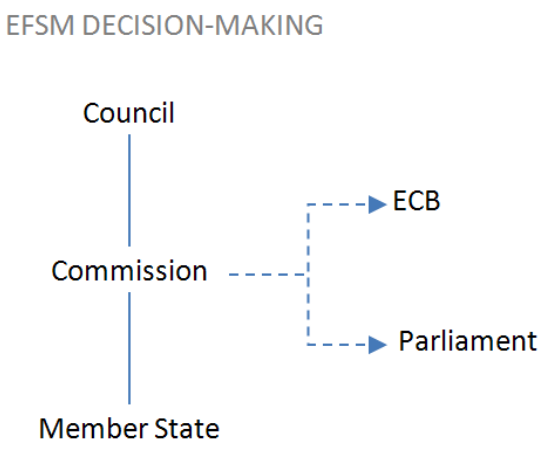
Results:

On May 2, 2010, the Euro zone countries and the IMF agree on a 110 billion euro (80 billion from the Eurozone, 30 billion from the IMF) three-year bailout package for Greece. Along with tax hikes, the bailout agreement calls for intensive cuts to the Greek budget, especially to pensions and public sector compensation.

In May 9, 2010, the Council creates the European Financial Stability Mechanism (EFSM) to preserve financial stability in Europe. The Mechanism foresees the possibility of granting Union financial assistance to a Member State in difficulties caused by exceptional occurrences beyond its control.

Within the framework of this mechanism, the Commission is allowed to contract borrowings up to €60 billion on the capital markets on behalf of the European Union. In addition, the Mechanism includes a special purpose vehicle (SPV), the European Financial Stability Facility (EFSF), which is established by intergovernmental agreement among all Euro area member states. The EFSF is authorized to lend up to €440 billion. Together, the EFSF and EFSM have a lending capacity of €500 billion.

Both the EFSM and EFSF frameworks state that strong economic policy conditions should be imposed on the receiving country in case of activation of this mechanism.



The EFSM decision-making is as follows: a member state applies for financial aid to the Commission, which informs the ECB and the Parliament (EP) and proposes a package of financial aid and conditionality for the member country to the Council. The Council then dictates a decision and, in case of a favorable reply, the Commission manages the package.

The EFSF is managed by a board of representatives from the 17 Euro zone member states along with a Chief Executive Officer and includes appointed observers from the European Commission and ECB. The EFSF is technically not directly accountable to the EP but a close working relationship is expected.

Context - May 2011 – Portugal and Ireland get bailout

The Irish government, reeling from a banking crisis that is much more severe than initially thought, successfully applies on November 29, 2010 for a €67.5 billion bailout from the EU and IMF. Meanwhile, Greece and Portugal's debt ratings are placed on downgrade watch by Standard and Poor's, bringing more uncertainty to the region.

The **European Commission** and **ECB** call for a larger EFSF.

> "Mr Schaeuble said he wants the Euro zone to do more than just bolster its crisis response fund, in order to "absolve us from the necessity to react again every couple of months". Both the European Commission and the European Central Bank (ECB) have called for an increase in the size of the EFSF, as well as giving it new powers, such as the right to buy up Euro zone government debt."
>
> - BBC News - "Euro up despite no sign of rescue fund deal" – January 18, 2011

France calls for further integration.

> "Germany and France want talks on changes to the EFSF to be linked to boosting Euro zone competitiveness through higher retirement ages, national laws to cap debt, a common corporate tax base and an end to wage indexing to inflation."
>
> - Reuters – "EU Finance ministers to discuss rescue fund" – February 13, 2011

Germany wants to avoid larger EFSF and calls for a competitiveness pact.

> "What we want to establish is a pact for competitiveness, and in so doing we want to make it very clear that we intend to grow together more closely on a political level," Mrs Merkel said […]"
>
> - BBC News – "France and Germany propose EU 'Competitiveness pact'" – February 4, 2011

> "The sources said that while there was agreement that the EFSF effective lending capacity should be boosted to the full 440 billion euros, there was no consensus yet on how to do that. One of the ideas, favored by Germany, is that countries with a triple A credit rating would increase their guarantees for the fund, while those below triple A would inject cash."
>
> - Reuters - "EU Finance ministers to discuss rescue fund"– February 13, 2011

Results:

On March 25, 2011, the European Council agrees on the details of the permanent European Stability Mechanism (ESM), which is to have a maximum lending capacity increased to €500 million and is designed to take over the EFSF and the EFSM after they expire. The agreement states that the ESM will be financed by all EU members, and that any country utilizing the mechanism for financial assistance can only do so under strict

conditions. The mechanism allows for Collective Action Clauses to be standardized by July 2013.

On May 3, 2011, Portugal reaches a bailout deal worth €78 billion with the European Union and the IMF, becoming the third European nation to be bailed out of a sovereign debt crisis.

Context - October 2011 – Italian Bond Yields Rise and Greece Debt

The concern of contagion in Europe spreads, as the ECB buys Italian and Spanish bonds in attempt to lower their borrowing costs and as it becomes clear that Greece will miss its next budget deficit targets. Italy passes a €50 billion-austerity budget but cannot avoid Standard and Poor's downgrading its public debt along with Spain's. Euro zone ministers debate whether to release the next tranche of loans to Greece and/or to write off a portion of its debt and whether there is an urgent necessity to recapitalize the region's banks.

France is against a private sector haircut and wants ECB funding for the EFSF.

> "France wants to have the European Central Bank at the centre of any effort to increase the firepower of the bailout facility, the EFSF. Germany does not. Germany wants bondholders to face much steeper "haircuts" on Greek debt. France does not - in part because of what it might mean for some politically important French banks."
>
> - BBC News – "Waiting game for euro crisis" – October 21, 2011

The **ECB** is against a private sector haircut and buys Spanish and Italian bonds.

> "France and the European Central Bank do not want to restructure Greek debt further, fearing market contagion and, for Paris, additional pressure on French banks that hold significant amounts of Greek, Spanish and Italian debt."
>
> - The New York Times – "Europeans Seek Bold Debt Deal, Despite Differences" – October 21, 2011
>
> "European Central Bank President Jean-Claude Trichet started buying Italian and Spanish assets today in his riskiest attempt yet to tame the sovereign debt crisis. Italian and Spanish bonds surged as the ECB entered the market, sending yields down the most since the euro began in 1999."
>
> - Bloomberg – "Trichet Draws ECB 'Bazooka' In Bond Purchases" – August 8, 2011

Germany wants a private sector haircut and is against ECB funding and expansion of the EFSF.

> "On Greece, Germany appears willing for a deal to restructure Greek debt to no more than half of its face value, to try to bring Greece's debt burden to a sustainable level. But Germany wants private investors and banks to accept such losses voluntarily to avoid a formal default, which would be a first for the Euro zone. […] France and Germany also disagree on how to leverage or maximize the $590 billion bailout fund to create a "wall of money" to discourage the markets from speculating further on Spain

> and Italy. The fund has already committed about $200 billion to Greece, Portugal and Ireland, and the German government has promised taxpayers that its own share, as the largest contributor, will not be more than $305 billion."
>
> - The New York Times – "Europeans Seek Bold Debt Deal, Despite Differences" – October 21, 2011

> "France wants to have the European Central Bank at the centre of any effort to increase the firepower of the bailout facility, the EFSF. Germany does not."
>
> - BBC News – "Waiting game for euro crisis" – October 21, 2011

Results:

The Summit held in Brussels results in an agreement on a "three-pronged approach": to stabilize Greece, revive confidence in the markets, and strengthen the banking system. Private banks holding Greek debt accept a write-off of 50% of their returns. The EFSF bailout fund is to be boosted to €1 trillion from the €250 million left in the fund, by leveraging the fund itself through guarantees and insurance to investors buying Euro zone debt, as well as through a special investment vehicle that could attract investment from countries like China or Brazil. European banks are required to raise around €106 billion Euros in new capital by June 2012.

Context – December 2011 – Greek Referendum Announced after Greek bailout agreement

Europe is thrown into further turmoil in early November, when Greek Prime Minister George Papandreou calls a surprise referendum on the recent bailout plan agreed upon in Brussels and eventually resigns amidst international pressure. The threat of contagion becomes much more real when Italian 10-year bond rates hit record and unsustainable highs above 7%. This leads Italian Prime Minister Silvio Berlusconi to resign, making way for a technocratic government led by Mario Monti, which is designed to alleviate some of the market and international pressure. Angela Merkel and Nicolas Sarkozy call for EU treaty changes in governing relations, but differ in the degree of involvement of the EU in national budgets.

European Commission pushes for Eurobonds.

> "The second proposal that has gained some traction is to issue Eurobonds (for the debts of one to become the debts of all). The EU Commission was pushing that solution yesterday."
>
> - BBC News - "Merkel and Sarkozy agree to disagree" - November 24, 2011

France is against the Commission's review of national budgets.

> "However, Mr Sarkozy rejected suggestions that national budgets could be approved and regulated in Brussels, and said France would not give up its sovereignty."
>
> - BBC News – "Merkel urges euro fiscal union to tackle debt crisis" – December 2, 2011

The **ECB** reduces interest rates.

> "You won't solve the crisis by reducing incentives for the Italian government to act," Weidmann, who also leads Germany's Bundesbank, told the Financial Times in an interview published yesterday. He also said that the ECB's benchmark interest rate is "appropriate" at 1.25 percent after last month's surprise quarter-point cut."
>
> - Bloomberg Businessweek – "ECB Officials Dismiss Calls for Backstop Role to Fight Turmoil" –November 15, 2011

Germany is against the ECB becoming the lender of last resort and reaffirms its stance on the necessity for incentives to reform and for more fiscal discipline.

> "A joint liability for others' debts is not acceptable," she said. "Eurobonds are not a rescue measure in this crisis." […] "We need budget discipline and an effective crisis management mechanism," she said. "So we need to change the treaties or create new treaties." […] Mrs Merkel promised "concrete steps towards a fiscal union" - in effect close integration of the tax-and-spend policies of individual Euro zone countries".
>
> - BBC News – "Merkel urges euro fiscal union to tackle debt crisis" –December 2, 2011

Results:

With the crisis having turned the corner past Greece to knock at the door of the rest of Europe, European leaders convene at the European Summit in Brussels on December 8, 2011 to create measures that will keep the crisis at bay and avoid a breakup of the European Union. On December 9, European leaders announce that 26 out of the 27 EU member states have committed to a tax and budget agreement. The United Kingdom, led by Prime Minister David Cameron, opts not to join the "fiscal compact".

The fiscal compact (to take effect March 2012), including penalties for countries that break deficit rules, will have to be implemented through a treaty between countries since unanimity is needed for the agreement to be established within the EU treaty. The compact is comprised of a cap of 0.5% of GDP on countries' annual deficits, automatic penalties for nations whose public deficits exceed 3% of GDP, and formalization of these more stringent rules in each country's respective constitution.

The starting date of the European Stability Mechanism is advanced one year, to July 2012, and its lending capacity of €500 billion is to be reassessed. Furthermore, the Euro zone and EU countries pledge €200 billion to the IMF.

Epilogue

The Council Summit held on June 28, 2012 was a turning point, at least on paper. With the threat of contagion and a further crippling crisis lurking at the door of the core economic EU countries, the EU finally step up, with a three-in-one approach to tackle the crisis head-on. Key decisions and actions must now be taken to implement the Summit's conclusions; their design and implementation will greatly affect the future of the Euro zone.

> "The three results [of the last summit] can be summed up to one: the euro civilization is still alive and kicking. [1] The emergency measures to overcome the Spanish-Italian turmoil [(]direct bank rescues… and direct purchases of (sovereign) bonds[)]; [2] The growth agenda drawn up by socialist France; [3] The prospect of a banking, economic and even political union [(]the ECB would lead the first of the three, undertaking the new supervision of the credit institutions [)]."
>
> Translated from: El País, Xavier Vidal-Folch – "Tres en uno" – June 29, 2012

This potential fulcrum reflects, in effect, the practical recognition of an important conclusion. The European sovereign debt crisis has clearly shown that the EU must become more than an economic union in order to survive and provide a prosperous environment for its members. In a speech in August 2011, EU Council President Herman Van Rompuy said:

> " The enemy of the European Idea, of peace and of solidarity is populism: "everyone for himself" or "me first".

This paper has shown that the corrective actions of the main players were often made with a shortsighted approach lacking in European scope and inspiration. Though the economic hemorrhage has been been stopped temporarily, the national approach of the players involved has generated a serious threat to the EU. For the European Union to move forward, economic integration must go hand in hand with fiscal integration and organizational-instrumental reform in order to allow for more fluid governance working in the best interests of all citizens of the union. Indeed, in the same speech, Van Rompuy stated:

> " There can be no continued European integration without an added extra. Without that spirit which can be summed up in two sayings: "together we are strong" and "unity in diversity". The scheming mind that seeks only economic and financial value will not succeed. More is required. Europe is not just self seeking."

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