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Europe's Bailout Politics

BY ROLAND VAUBEL

An exercise in policy heavy-handedness.

It is well-known that the bailouts of Greece, Ireland, and now Portugal are a breach of the European treaties. Even Christine Lagarde, the French finance minister, and Karel de Gucht, the Belgian EU commissioner, have admitted that. What is less well known is that the International Monetary Fund, too, by contributing to these loans, is violating its charter.

According to the IMF Articles of Agreement, a member state may obtain IMF credits only on the condition that it has "a need to make the purchase because of its balance of payments or its reserve position or developments in its reserves." Greece, Ireland, and Portugal are certainly not short of foreign exchange reserves—only the European Central Bank is entitled to sell foreign exchange. Nor is the IMF lending to any of these countries because of its balance of payments. All three countries, it is true, have experienced a (moderate) decline in their net capital imports in 2010, but this is not why the IMF is giving them cheap credits. The IMF is lending because of budgetary problems, and that is not what it is supposed to do. The Deutsche Bundesbank made this point very clear in its monthly report of March 2010: "Any financial contribution by the IMF to solve problems that do not imply a need for foreign currency—such as the direct financing of budget deficits—would be incompatible with its monetary mandate." IMF head Dominique Strauss-Kahn and chief economist Olivier Blanchard are leading the IMF into forbidden territory, and there is no court which can stop them.

A FRENCH SCRIPT

The self-acclaimed initiator of the euro bailouts has been French President Nicolas Sarkozy. In the morning and afternoon of May 7, 2010, prior to the historic working dinner of that day, he had bilateral talks with EU Commission President José Manuel Barroso, ECB President Jean-Claude Trichet, and Eurogroup President Jean-Claude Juncker, all of whom concurred with him. Barroso is Portuguese. The Commission itself has a vested interest in the bailout funds which increase its power and prestige. The same is true of Juncker, the prime minister of Luxembourg. Trichet will return to France in October and is looking for new responsibilities. Sarkozy can give him a helping hand.

Sarkozy has claimed that he has "saved the euro"—currency union being the return which France had requested in exchange for agreeing to German unification in 1990. But he may also have liked the idea of being admired as Europe's leading crisis manager and as head of the European Union's

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"Mediterranean Union" which he had founded two years earlier. Moreover, more Greek bonds were held by French banks (€31 billion) than by German banks (€23 billion). Finally, as an opinion poll by IFOP revealed in January, 61 percent of the French believe that their country might get into the same difficulties as Greece; the equivalent percentage in Germany is only 34 percent.

At the working dinner, Trichet presented a prepared statement with charts, and he concluded that a Lehman-type panic might break out unless Greece were saved by its partners. Chairman Juncker had placed Trichet as second speaker, right after the Greek prime minister. These two speeches impressed many participants—few of them economists. Angela Merkel, the German chancellor and a physicist who grew up in East Germany, concluded that the bailout was an "ultima ratio" and that there was no alternative.

In fact, the situation was in no way comparable to the systemic failure worries that attended the fall of Lehman Brothers. When Lehman Brothers collapsed in September 2008, there was considerable uncertainty whether, as in the Great Depression, a series of bank failures and a contraction of the money supply would follow. By 2010, in contrast, all EU member states had guaranteed the survival of their banks and had installed rescue funds well-equipped to support their banks. For example, SoFFin, the German rescue fund, had €50 billion of unused resources at its disposal. If Greece had failed, no bank would have collapsed due to its holdings of Greek bonds, and the same was true for Ireland and Portugal. Moreover, up to now, none of these governments has been unable to borrow in the private capital market. They are merely trying to avoid paying the high risk premia.

Guaranteeing the survival of European banks would have been much cheaper than guaranteeing the public debt of Greece, because a large portion of Greek bonds are held by non-banks. In the Academic Advisory Council to the German Ministry of Economic Affairs and Technology, we calculated that the cost of buying all Greek, Irish, Portuguese, and Spanish government bonds from all banks in the eurozone—not only the weak banks—would have been less than half the cost of the bailout package, that is, €254 billion instead of €520 billion (or from 2013 onward, €720 billion). If Greece, Ireland, and Portugal had been unable to service their debt, they should have rescheduled it as Russia did in 1998. The Russian moratorium did not cause a crisis. The creditors, not the taxpayers, ought to be the first to pay.

WILL THERE BE SOVEREIGN INSOLVENCIES?

Recently, the Eurogroup and the European Council agreed that the member states receiving credits from the bailout funds would not have to restructure their debt if they are merely having liquidity problems. Only "in the unexpected event that a country would appear to be insolvent" would it have to negotiate a comprehensive restructuring plan with its private-sector creditors.

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The distinction between illiquidity and insolvency is a matter of definition. It may be argued that any state which still owns enterprises, buildings, land, and highways, for example, must be classified as solvent. The decision whether the sovereign debtor is illiquid or insolvent shall be taken "on the basis of the debt sustainability analysis conducted by the Commission and the IMF, in liaison with the ECB." Taken by whom? The heads of state or government! Moreover, their decision "will depend… on potential implications for euro-area financial stability" (European Council, Conclusions, March 24/25, 2011). Thus, as under the inglorious Stability and Growth Pact, the decision will be taken by politicians on the basis of a report from the Commission (which in this case is co-authored by the IMF). The debt sustainability analysis will not trigger any automatic effects.

The history of the Stability and Growth Pact provides abundant evidence that this will not work. It is extremely unlikely that any member state will ever be declared insolvent and be asked to restructure its debt. The governments of the eurozone have united to insure each other against the critical judgement of the market.

It is well known from insurance economics that such subsidized credits create moral hazard. That is, they weaken the incentive to avoid excessive deficits in the future, and they increase the demand by banks for the bonds of such profligate governments. The bailouts create more serious incentive problems than the other EU transfers, such as the Structural Funds. The subsidized bailout credits are not paid because the recipient countries are poor, but because their politicians have piled up too much debt. ◆