THE EMU SOVEREIGN-DEBT CRISIS: A CALL AND AN OPPORTUNITY FOR A GREEK SUPPLY-SIDE REVOLUTION*,**

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Abstract

We summarise the findings of a research project we have recently completed on the European sovereign debt crisis. We find a marked shift in market pricing behaviour from a 'convergence-trade' model before August 2007 to one driven by macro-fundamentals and international risk thereafter. We do not find evidence of any significant role for momentum-trading speculation in the CDS market. The escalation of the Greek debt crisis in November 2009 is confirmed as the result of an unfavourable shift in market expectations, caused by the hesitation of Greek authorities to commit to structural reforms. This shift is specific to Greece, explaining the difference in spread values between Greece and other periphery countries. The majority of EMU countries have experienced contagion from Greece. Our findings highlight the necessity of structural reforms in periphery EMU countries increasing competitiveness; and institutional reforms enhancing intra-EMU economic monitoring and policy co-ordination. For Greece, the crisis calls for a thorough plan of economic reconstruction, not short of a supply-side revolution, aiming to reform the deeply problematic public sector and substantially improve competitiveness. We hope and believe that this opportunity will not be missed.

*The research project to which the article refers to was completed during our research visit to the European Commission, DG-ECFIN in summer 2010. The views expressed are the authors' alone and do not necessarily correspond to those of the European Commission.

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1. Introduction

Recent months have seen the transformation of the global financial crisis into a sovereign debt crisis in the euro-area. Starting from Greece in autumn 2009, the euro zone debt crisis has since caused Greece to withdraw from international bonds markets and put intense pressure on the bonds of other EMU countries, most notably Ireland, Portugal and Spain. The intensity of the crisis has prompted European policy makers to take extraordinary measures aiming to limit its fall-out on the real sector of the affected countries and prevent its further spreading. These measures, ratified in May 2010, include an unprecedented in size (110 billion euros) three-year EU/IMF-financed emergency rescue package for Greece; and the creation of a European stabilisation mechanism ring-fencing 750 billion euros for countries that may find themselves in a position similar to the Greek one within the following three years. These measures, however, have so far not proved enough to ease the crisis. Greek spreads remain at very high levels, the Greek economy has fallen into a deep recession, while the spreads of the remaining periphery EMU countries have increased further in recent months. These developments have preserved a lively debate ranging from the optimum short-run response to the crisis to the eurozone's overall long-term sustainability.

With so much political and economic capital at stake, the economics' literature has responded to the eurozone crisis through a series of empirical studies. The consensus emerging from this literature is summarised in two main findings. First, both the amount and the price of the perceived global risk associated with investments in sovereign bonds, relative to the safe havens of US and Germany, have increased during the global economic downturn. This explains the across-the-board increase in EMU spread values. In this process, the transfer of banking sector risk to sovereign borrowers, through bank bail-outs, has been central. Second, intra-EMU differences in spreads' increases are explained by heterogeneous transfer of banking sector risk to sovereign borrowers and the pricing of heterogeneous macro-fundamentals. The penalties imposed by markets are further exacerbated by the interaction of macro-fundamentals with the common international risk factor.

Existing studies have shed much-needed light on the factors driving increasing EMU spreads, greatly enhancing our understanding of the eurozone crisis. Important questions, however, still remain unanswered. First, almost all existing studies are purely empirical. However informative, without a theoretical mapping to the events it aims to analyse no study can offer a full set of explanations and traceable future policy implications. Second, existing studies have not explained the events characterising the most recent and intense phase of the crisis. Why did the Greek spread escalate from 140 basis points in early November 2009 to

250 points by the end of the year and nearly 600 in late March 2010? Third, why has the Greek spread been taking so much higher values compared to other periphery countries? Is the Greek macro-outlook so much worse than Portugal's to justify spread values two or three times as high? Fourth, has contagion really taken place? Despite this widely held belief, the vast majority of existing studies have not tested the hypothesis of contagion explicitly. Finally, what are the forces determining the cost of insurance against sovereign default during the crisis? Speculative trading in the market for credit default swaps (CDS) has been suggested as one of the potential culprits behind the present turmoil, with subsequent proposals ranging from tighter regulation of the CDS market to an outright permanent ban on naked CDS trading. Are such proposals justified or is the role of CDS speculation overestimated in the ongoing debate?

2. Main findings

In a recent paper titled "*The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*" we address each of the five questions posed above. Our empirical investigation is based on the theoretical analysis by Arghyrou and Tsoukalas (2010), the main premise of which is that the eurozone debt crisis is a currency crisis in disguise. This is caused by systemic macro-risk which in the absence of national currencies is diverted into the markets for sovereign bonds. Arghyrou and Tsoukalas use insights from the literature on currency crises to build a theoretical model of the eurozone debt crisis offering testable hypotheses relating to all five questions posed above. In Arghyrou and Kontonikas (2010) we put these hypotheses directly to the test. Using monthly data covering the period January 1999 – February 2010 and a range of estimation techniques we reach the following findings:

First, prior to the global credit crunch (January 1999 – July 2007), with the possible exception of expected fiscal deficits, markets priced neither macro-fundamentals nor the very low at the time international risk factor. Markets, however, have changed drastically their pricing behaviour since August 2007. During the crisis period, markets have been pricing both the international risk factor and macro-fundamentals on a country-by-country basis.

Second, the Greek debt crisis is due to a background of deteriorating macro-fundamentals over 1999-2009 and a double shift in private expectations. Starting from November 2009, Greece was transferred from a regime of fully-credible commitment to future EMU participation under the perception of fully guaranteed (by other EMU countries) fiscal liabilities, to a regime of non-fully credible EMU commitment without fiscal guarantees. This regime-shift was the result of the reluctance of Greek authorities to commit to a reform programme reversing the hitherto unsustainable trends in Greek public and external debt. This shift in expectations explains not only the sudden escalation of the Greek debt crisis in November 2009 but also the difference in spread values observed between Greece and other periphery EMU countries. Compared to Ireland, Portugal and Spain, markets perceive a much higher probability of a Greek y exit from the EMU, and/or a Greek default. In short, Greece's problems are as much about trust as they are about economics.

Third, the majority of EMU countries have experienced contagion from Greece, most prominently Portugal, Ireland and Spain. The Greek bond yield has now become a proxy for EMU-specific systemic risk, increasing government bond yields in other EMU countries beyond the level justified by international risk and idiosyncratic fundamentals. In short, the Greek problem has become an EMU-wide problem.

Finally, we provide some initial evidence suggesting that momentum-driven speculation is not the sole driver of widening CDS premia during the crisis. The higher cost of insurance against sovereign default appears to reflect both country-specific and international risk considerations. This does not imply that speculation through the CDS market is not taking place or it does not drive EMU spreads at higher data frequencies. But it does imply that EMU spreads are mainly driven by accumulated intra-EMU macroeconomic imbalances and international risk conditions. Although the latter may improve as the global economic environment gradually improves the former is unlikely do so without significant intra-EMU economic/institutional reforms.

Overall, for the pre-crisis period our findings provide support to the "convergence trade" hypothesis according to which markets were discounting only the best-case scenario of full convergence to German fundamentals, even for periphery EMU countries displaying a clear deterioration of their macro-fundamentals. This can be explained on three factors: First, conditions of amble global liquidity and low risk over the best part of the past decade; second, expectations that euro-accession would result in growth-inducing reforms in periphery EMU economies; and third, lack of a mechanism establishing credibility for the "no-bail out" clause of the Maastricht Treaty. With the benefit of hindsight, it can now be argued that markets were operating under a perceived guarantee according to which there was very little default risk associated with investment in EMU sovereign bonds, rendering them a "heads-you-win, tails-you-do-not-lose" bet. Convergence trading, combined with the absence of an effective EU-sponsored mechanism of economic monitoring, relaxed market pressure on EMU governments to improve fundamentals thus resulting into further real divergence. The increasing un-sustainability of this divergence was bound to result into a change in market behaviour. The trigger was the onset of the global credit crunch in 2007 which prompted markets to switch to a more rational bond pricing model based on international risk and idiosyncratic macro-fundamentals. If this change proves permanent, as it did in the US following the New York debt crisis in 1975, then it will mark the ascent of a new era where markets will be imposing much higher penalties on macro-imbalances. As a result, although a gradual normalisation of the global economic outlook may narrow EMU spreads, as long as intra-EMU macro-imbalances persist spreads are likely to remain in relatively high levels.

3. Policy implications: Towards a resolution of the euro-crisis

3.1 EMU: Enhanced monitoring, co-ordination and reform

Our findings have policy implications both at the national as well as the union level. At the union level the crisis has highlighted the necessity of institutional reforms in two directions. First, to prevent future debt crises the EMU must develop effective mechanisms of fiscal supervision and policy co-ordination. Second, if a crisis does occur, it is important to prevent its escalation in the affected country and its contagion to others. This can be achieved through the creation of a permanent EMU-run mechanism of emergency financing. For such a mechanism to be successful in stabilising expectations, its rules and terms must be transparent and known ex-ante. At the same time, the terms of emergency finance must be such as to eliminate the risk of moral hazard discouraging fiscal discipline and necessary reforms. Identifying rules achieving both objectives simultaneously is a challenging task for academics and policy-makers alike. Recent proposals calling for a European emergency finance mechanism ultimately allowing for an orderly default of EMU members and to which contributions will be linked to a country's fiscal position, move towards that direction.

At a country level, our findings imply that within the new environment of rational, fundamentals-based bond pricing, for EMU-periphery countries to achieve sustainable low spread values they must secure a marked improvement in their external competitiveness and fiscal position. As far as the immediate future is concerned, periphery countries can achieve a noticeable reduction in spreads only if they maintain the confidence of markets that they are fully committed to the objective of a permanent improvement in macro-fundamentals. This can only be achieved through a credible and realistic strategy of structural reforms, backed by evidence of its determined implementation. Without such evidence markets will continue to doubt the sustainability of these countries' participation in the EMU, and the risk that these expectations will become self-fulfilling will remain.

3.2. Greece: The case for reform through a supply-side revolution

In relation to the country at the epicentre of the eurozone debt crisis, Greece, the key structural reforms we are calling for aim to address the two long-standing fundamental weaknesses of the supply side of the Greek economy primarily responsible for its near-collapse in 2009-10. These are the exceedingly large and inefficient Greek public sector and the low degree of competitiveness of the Greek private sector. These shortcomings date back to the 1980s and have led Greece to a position similar to that of central and eastern European countries in the early 1990s. That is in the immediate aftermath of the collapse of an outdated, state-run, business-unfriendly economic system. This system can neither be preserved nor be repaired. It has to be fundamentally re-built. As shown by the experience of countries such as the Czech Republic and Slovenia, macroeconomic performance and living standards can be substantially improved within a reasonable period of time, even under initial conditions much less favourable than those currently faced by Greece, which has the advantage of strong financial support from its European partners. But for this objective to be achieved there is no room for populist measures and *passé* ideological pre-conceptions. What Greece needs is a thorough, realistic and credible plan of economic reconstruction. In short, Greece needs a supply-side revolution.

As mentioned above, the founding stones of the supply-side revolution we argue for are the reconstruction of the deeply problematic Greek public sector and a substantial improvement in the level of Greek competitiveness. As far as the former is concerned, the Greek state should become smaller in size, cease funding loss-making state-owned firms and establish a non-politically controlled administration system able to reduce the rampant tax evasion and waste of public funds in sectors such health care and local administration. With regards to the latter, Greek private production should be re-oriented towards offering goods and services of high quality in competitive prices. To that end, a necessary condition is a reduction in the price of Greek production relative to that of Greece's main trading partners. This, in turn, has two prerequisites. First, a reduction in the Greek unit cost of production; second a reduction in the high level of monopolistic mark-up that Greek firms currently incorporate into their prices.

These bring us to the core of the supply-side revolution we argue for. To achieve these objectives Greece must proceed to (a) the opening of all markets to full competition by abolishing all state-run and sector-specific monopolies; (b) the reform of the over-regulated Greek labour market by introducing flexibility which in countries applied contributed towards reducing unemployment, increasing labour income and improving labour conditions; (c) the reduction in many unjustifiably high wages in the wider Greek public sector and state-owned firms; and (d) the creation of a business-friendly economic environment making the country attractive to internal and foreign investors. Investment spending and foreign direct investment in particular, are necessary for productivity improvement through the introduction of new technologies. But for Greek and foreign investors to undertake investment projects, it is necessary for Greece to reduce its exceedingly high direct and indirect business taxation, eliminate the unacceptably high current level of bureaucracy and corruption and establish confidence for the application of the rule of law in all aspects of economic and civil life.

Measured against the benchmarks of the post-1974 Greek consensus, the reforms proposed above may sound radical and non-feasible. We believe, however, that they are not. What we regard as non-feasible is precisely the continuation of this consensus, which has led Greece to the brink of economic collapse. There should of course be no illusions. The transition from an outdated, state-run economic model to a modern, dynamic, extrovert one will be neither easy nor immediate. Greece, however, has no other choice: the debt crisis it currently undergoes is the final confirmation, if one was needed, that the country has no more the capacity of continuing on the same path. What Greece has, by contrast, is a great opportunity: To convert the disappointment currently engulfing Greek society by the failings of the *ancien régime* to a platform enabling her to achieve long-overdue and greatly beneficial structural reforms. We hope and believe that this opportunity will not be missed.

References

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