A question of interest

Greece and the original sin of the euro crisis

by Athanasios Orphanides, Advisory Board

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The mismanagement of the euro crisis has its roots in the currency area's flawed political structure. A study of the European Union and International Monetary Fund programme imposed on Greece in May 2010 highlights both the nature of the problem and the difficulty in resolving it.

Governments of some member states – particularly Germany – were able to exploit problems in others to support their own interests. The May 2010 programme was the original sin of the euro area crisis. Rather than help Greece, it was designed to protect specific political and financial interests in other member states, above all France and Germany.

By applying its established lending framework, the IMF could have helped contain the crisis and resolve it effectively. However, its role was counterproductive. Using a legitimate concern – the risk of contagion – as a pretext, it underwrote a programme that shifted crisis losses to Greece that other euro members could have borne.

At the end of 2009, Greece faced questions about the sustainability of its government debt, along with macroeconomic problems commonly encountered in countries turning to the IMF. Greece's euro membership created additional challenges – the government had relinquished control of its own monetary and exchange rate policy, tools it could have used to defuse the crisis.

An IMF programme for Greece required coordination with other euro area governments and institutions. The Greek programme effectively became subject to the approval of each of the other euro governments, making decision-making dependent on other states' competing financial and political interests.

Proper crisis management should minimise the total economic cost and manage a fair distribution of losses. However, in the euro area political survival of elected governments demands that leaders focus on public opinion in their own state, regardless of whether this leads to harmful decisions for other states and the euro area as a whole. Using the US as a benchmark, the data suggest that crisis mismanagement has generated a sustained annual loss in the euro area of about 10% of GDP per person. Among euro area member states, Germany has been by far the biggest and perhaps the only winner.

In Greece, the intra-euro area nominal exchange rate had to remain fixed. As a result, more of the adjustment burden had to occur via internal devaluation – a relative decline in domestic prices and wages. This is a slower process than an adjustment through nominal devaluation, suggesting that a successful IMF programme might have required a more gradual fiscal adjustment to avoid an austerity-induced economic collapse.

Euro area politicians have tried to shape public opinion in a manner favourable to their own interests. Politicians in different member states have attempted to avoid blame and, if possible, shift it to others, generating animosity and mistrust.

Available information suggests that IMF management was fully aware that the Greek programme that its board approved on 9 May 2010 was doomed to fail; it was already planning subsequent modifications, including a restructuring of the debt for a later time.

There is no denying that Greek government policies started the problem in Greece. However, had key governments not interfered with the process, and had the IMF designed a programme that respected its own rules, the Greek crisis would almost certainly have been resolved long ago without the destruction of the past five years.

The May 2010 programme protected German and French financial institutions from financial losses, and the Berlin government from political costs. But it also led to a catastrophe in Greece and set a precedent for crisis mismanagement. The euro's political and economic framework has encouraged conflict over co-operation. This has proven disastrous for the euro area as a whole and ultimately for Europe.

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