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Commentary

The role of politicians in inciting financial markets to attack the eurozone

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Despite multiplying good news from the real economy, the past six months have been the most testing for the euro area since the acute phase of the financial crisis at the end of 2008. Mounting doubts on the sustainability of sovereign debt are pushing spreads over the German Bund rates to unprecedented heights.

The sustainability of sovereign debt is a serious issue that must be confronted: the combination of large public sector deficits to support economic activity and persistently weak private demand raises questions of debt sustainability in the medium term. However, financial markets seem to have blown these fears out of proportion, leading to a full-scale confidence crisis: after all, Greece's public debt is a tiny proportion of eurozone GDP and bank capital and there are no serious grounds for believing that another eurozone member will become insolvent any time soon. Evidence presented below suggests that politicians' public disagreements and careless statements at critical junctures may have added oil to incipient fire: by creating the impression that domestic political interests would take precedence over orderly management of the Greek debt crisis, they raised broader doubts on their ability to address fundamental economic divergences within the area, which are the real source of debt sustainability problems in the medium term.

The figure at the end of this commentary reports daily spreads for 10-year government debt between Germany, on the one hand, and Greece, Portugal, Spain, Italy and France on the other. We have also indicated in the figure significant events that coincided with observed changes in spread patterns (events are indicated with numbers referring to the events chronicled in the list that follows).

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Thinking ahead for Europe

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As may be seen, up until the beginning of February 2010, by and large the Greek crisis is just that, a Greek crisis, reflected in the widening spread relative to all other government paper. But in the ensuing weeks all spreads start to widen and in the period of most acute instability in April and May all spreads follow similar patterns both in their upswings and downswings – albeit in different scale. Markets were somehow coming to believe that government insolvency would spread from one country to another, leading eventually to a banking crisis.

Let's consider events at critical changes in market spreads. On 8 December 2009, Fitch cut its rating on Greek debt below A grade (event 1), calling markets' attention to a deteriorating outlook; but the real jump in the spread, 170 basis points raising it to nearly 400 basis points, happens in the fortnight following the announcement that debt data had been falsified on 12 January 2010 (event 3). On that occasion, Chancellor Merkel declared that Greece's mounting deficits risked hurting the euro; the statement was subsequently removed from the German government website.

The ensuing days were marked by confusing public statements, with reassurances by the European Commission apparently pushing spreads down (events 5 and 6) and tough German statements pushing them back up (events 7 and 8). March was also marked by great confusion, with Greece declaring that financial assistance was not needed and Germany implicitly using that statement to reassure domestic public opinion that German money would not be called upon. Germany and other member states at that time also called for the IMF to intervene in case of need. The effect was renewed uncertainty on the real willingness of eurozone members to support Greece.

On March 25th eurozone member states agreed on a rescue package for Greece involving bilateral loans as well as IMF financing (event 11); however, Greece still refused to ask for it while the eurozone member states started bickering in public over the conditions applicable to the loan – with Germany demanding above-market rates that would of course make Greek debt even less sustainable; the request was later withdrawn (event 13-a). The spread on Greek paper trespassed 400 basis points and started climbing to new heights since early April; other spreads also rose sharply. The key novelty here seems the decision, taken on April 11th, to extend aid *through bilateral loans* (€30 billion from euro area member states, to be supplemented by the IMF; event 13-b), a decision that for the first time focused market attention on the fact that eurozone governments would be directly liable for Greek debt – trashing the no-bail out clause of the Treaty.

Following pronounced market unrest, on May 2nd the eurozone member states agreed on a €110 billion support package for Greece (of which €30 billion would come from the IMF, event 19), and Greece announced that it would finally take it. However, after initially receding, spreads widened again even more, with confidence fading in the whole eurozone. An emergency meeting of the Ecofin Council then agreed on a new European Financial Stabilisation mechanism entailing loans and guarantees up to €750 billion – of which €440 billion would be raised through a new collective instrument, the

Special Purpose Vehicle (SPV) entitled to raise money from world capital markets, €60 billion from the European Commission and the rest from the IMF (event 21). No more bilateral loans: the lesson has been learnt, at a high cost. The ECB followed suit and on the same date announced a new package of liquidity support to meet renewed distress in the interbank market. The package included direct purchases of Greek and other eurozone government debt bonds by the European Central Bank.

However, upon returning home, Mrs. Merkel announced a unilateral German ban on short selling that once again unsettled markets and pushed up spreads on the Bund (event 23), since it was seen as further indication of insufficient coordination. A German member of the ECB governing board publicly voiced his disagreement with ECB support to the sovereign debt market. After coming down sharply in the days immediately following the new measures, spreads have been crawling up in a climate of mistrust and confusing statements by eurozone governments. Good news from the economy and agreement within the Eurogroup on the Special Purpose Vehicle (event 24) has so far not managed to calm the waters.

In sum, governments may have contributed quite a bit to the turmoil with their public displays of confusion and their statements to assuage domestic public opinion: because their behaviour undermined the credibility of the specific actions they were taking and, more broadly, of their ability to effectively address underlying imbalances in the eurozone. The good news is that even this confused and ill-advised bunch was eventually forced to come together and approve unprecedented measures to rescue the euro from disaster. At the recent meeting of the European Council on June 17th, they have now agreed to publish in July the results of stress tests on 25 large banks in the area (event 26) – which should help dissipate uncertainty on their real exposures. If eurozone governments continue to show unity of purpose and the serious intention to address underlying imbalances threatening the sustainability of the euro, there is hope that financial markets will relent and accept that the eurozone is not about to crumble.

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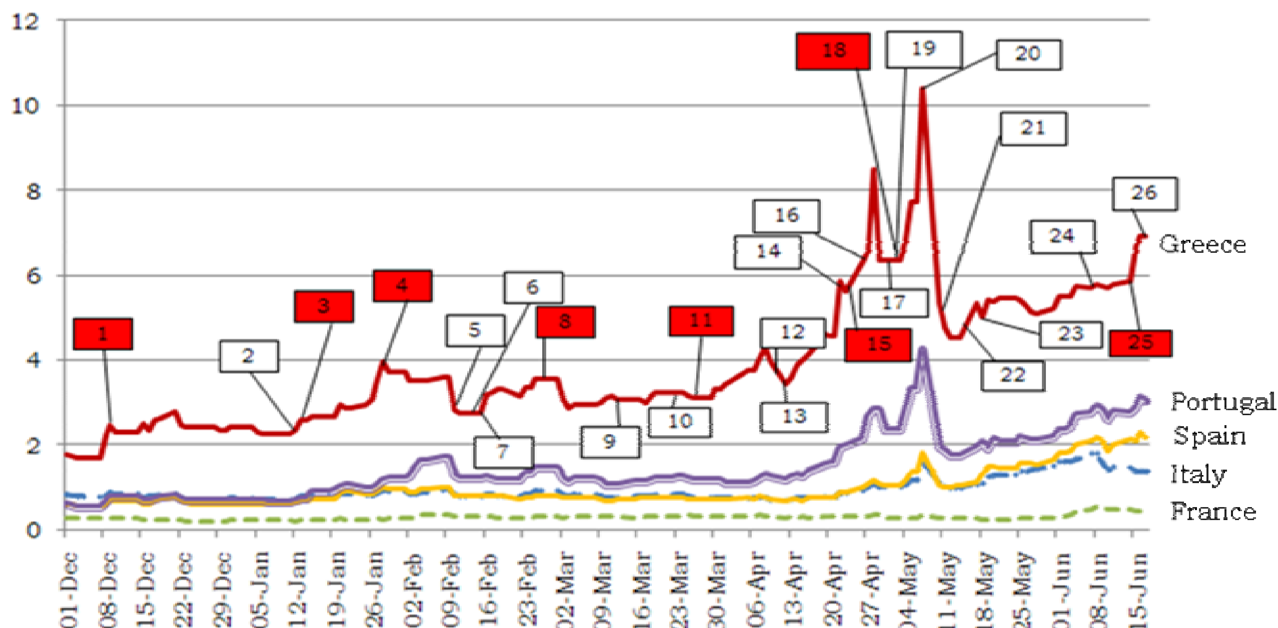
*10-year government bonds spread versus German bund for selected eurozone countries, December 2009-June 2010 (in percent)**



* Daily data. **Especially bad news appears in red.**
Source: Financial Times on Thomson Reuters.

Timeline of significant events

December 2009 – June 2010

1) **8 December**: Fitch cuts rating on Greek debt to BBB plus with negative outlook -- first time in 10 years a leading rating agency has rated Greece sovereign paper below A grade.

2) **11 January**: IMF announces mission to Athens.

3) **12 January:** Greece is condemned by the European Commission for falsifying data on its public finances. Angela Merkel says that Greece's mounting deficit risks hurting the euro, which faces a "very difficult phase" in the coming years (comment posted on a government website and later removed). Three days later Merkel praises the "Herculean effort" of Greek government to tame the budget deficit.

4) **28 January**: Bungled attempt by Greece to sell government debt to China becomes public.

5) **9 February**: EU Commission (Olli Rehn) offers “support in broad sense” to Greece – German government reported to be preparing an assistance package for Greece, though depending on “strict conditions”.

6) **11 February**: Eurozone leaders promise support to Greece in exchange for deficit reduction plan.

7) **15 February**: Greece to lose voting privileges in the EU in case of bailout, says Kurt Lauk, head of CDU’s Economic Council.

8) **24 February**: Hans Michelbach, influential CSU lawmaker, says that Germany must resist any move to provide financial aid to Greece because any assistance would provoke a “spiral without end”.

9) **11 March**: Wolfgang Schäuble calls for tough sanctions to back an EMF (European Monetary Fund), so as to enforce budgetary discipline, including expulsion from eurozone as a last resort sanction.

10) **21 March**: Merkel: “I do not see Greece needs money at the moment, and the Greek government has confirmed that. We do not want to create unrest in the markets by raising false expectations.”

11) **25 March**: Euro area agrees on emergency plan for Greece, but immediately after divergent interpretations of agreement surface between member states and unsettle markets.

12) **9 April**: German government demands emergency financial aid to Greece be at close to market rates.

13) **11 April**: a) Germany agrees to lend to Greece at below market interest rates; b) Eurozone members commit to provide up to €30 billion in loans to Greece, to be supplemented by money from the International Monetary Fund that could yield an additional €15 billion.

14) **22 April**: Moody’s cuts Greece’s rating for the second time in the year. German government lawmaker Frank Schaeffler says Greece should be prepared to leave the euro region if it can’t push through enough austerity measures to cut its budget deficit.

15) **23 April**: Greece asks activation of eurozone/IMF loan – EU says terms of aid may be agreed in a matter of days, but Merkel says Greek government must satisfy very stringent conditions.

16) **26-27 April**: Merkel says she won’t give funds until Greece shows it has a sustainable credible plan to cut its budget deficit – “I have said for weeks that Greece must do its

homework first"- "Germany will help when the correspondent conditions are fulfilled". Standard and Poor's downgrades Greece's long-term credit rating to junk.

17) **29-30 April**: emergency multi-annual loan programme for Greece from eurozone and IMF announced to be concluded within days. Greece adopts €24 billion austerity package – Merkel confident it will keep the euro stable.

18) **1 May**: Merkel says EU should be able to temporarily revoke voting rights from member states who violate deficit limits.

19) **2-3 May**: €110 billion eurozone-IMF support package for Greece adopted. ECB relaxes collateral policy for Greek sovereign debt.

20) **7 May**: German Parliament approves law to release funds (€22.4 billion) to Greece.

21) **10 May**: EU stabilisation mechanism adopted (€500 billion from eurozone and EU; €250 billion from the IMF). European Central Bank adopts package of measures to ease tensions in financial markets, including purchase of eurozone government bonds and reactivation of US dollar swap lines with the Federal Reserve. German court refuses to block Athens rescue.

22) **15-16 May**: Merkel: "if euro fails, more fails". Germany calls for eurozone budget laws (based on German model).

23) **18 May**: Germany adopts ban on short-selling.

24) **7 June**: Eurozone ministers establish the €440 billion SPV (the European Financial Stability Facility) envisaged in the May 10th package and find an agreement on its functioning.

25) **14 June**: Moody's downgrades Greek sovereign debt to junk.

26) **17 June**: EU leaders decide that detailed results of stress tests on the health of 25 big European banks be made public.