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THE DEBT CRISIS IN GREECE AND THE EURO ZONE

Greece is struggling with the most serious economic crisis ever seen since it has joined the Euro zone and adopted the Euro currency. The county's public debt has reached 290 billion Euros this year. The ratio of the public deficit to GDP which is 12,7 % in Greece is four times higher than the level allowed in member countries within the Stability and Growth Pact. Before evaluating the economic situation of Greece, it is necessary to give an overview of the structure of the Economic and Monetary Union of the European Union.

Within the framework of the Economic and Monetary Union, the EU countries have to meet some macro economic convergence criteria called the "Maastricht criteria" in order to adopt Euro as their currency and to join the Euro zone. The Maastricht criteria are the following:

- An inflation rate no more than 1.5 percentage points higher than the average of the three lowest inflation rates of EU member states over the previous year.
- Long-term interest rates must not exceed by more than 2 percentage points the lowest inflation rates of EU countries over the previous year.
- The Member Stated is required to join the exchange-rate mechanism (ERM II) for two consecutive years before entering the Euro zone and it should not have devalued its currency during the period.
- A government budget deficit must not exceed 3 percent of each country's GDP at the end of the preceding fiscal year
- A gross debt to GDP ratio must not exceed 60 percent at the end of the preceding fiscal year.

The monitoring of countries that have joined the Euro zone is relying on a concrete and measurable method with the Stability and Growth Pact. The Pact constitutes a framework with rules for coordinating national financial policies within the Economic and Monetary Union. The existence of strong financial policies for the good functioning of the Economic and Monetary Union is crucial.

The Stability and Growth Pact has foreseen a two level strategy made up of preventive and dissuasive approaches in order to prevent excessive budget deficit.

Within the preventive approach, in order to prevent excessive public debt, Member States must submit annual stability or convergence programmes to the European Commission. These programmes show how Member States are intending to achieve or maintain sound fiscal

positions in medium term. The Council will give its Opinion. The preventive approach strategy has two policy instruments:

- Following a proposal made by the Commission, the Council, can address an early warning to prevent the occurrence of an excessive deficit.
- Using the policy advice, the Commission can directly address policy recommendations to a Member State regarding to the broad implications of its fiscal policies

The dissuasive approach of the Pact is related to the excessive deficit procedure (EDP). The EDP is triggered by the deficit breaching the 3% of GDP threshold of the Treaty. In the case it is decided that the deficit is excessive according to the Treaty, the Council will issue recommendations to the Member States concerned to correct the excessive deficit and will provide them a time frame for the implementation of these recommendations. Non compliance with these recommendations will trigger further actions within the procedures, and to some extent there is the possibility of sanctions for Member States of the Euro zone.

The increase of public debt in Greece raised concerns about the risks of debt sustainability and crisis. In October 2009, when the government that came into power announced the public deficit was 12,7% of the GDP whereas the previous government had stated that the deficit was at 5%, it has been revealed that Greece has misled Eurostat with incomplete data. Since the public debt and deficit were above the limits, the reliability of the data is now being questioned. Furthermore the lack of transparency has affected negatively the investors.

Following these developments, the international rating agency Fitch has cut Greece's credit rating from "A" to "A-" in October 2009. The fact that the government revised its expectations for the budget deficit has influenced the decision taken by the agency. Within the same month, the budget deficit has been revised once more and it has been fixed to 12,7%. In November 2009, with the presentation of its draft for the 2010 budget, the new government aimed to reduce its budget deficit to 9,1% of the GDP in order to improve the financial situation of the country. In parallel, it is foreseen that the public debt that was 113,4% of GDP in 2009 will increase to 121% in 2010. However, the previsions made by the European Union for the same economic indicators are more pessimistic. The government's efforts to overcome the market's preoccupation were not sufficient, thus Greece's prime risk has increased. Since Greece's credibility regarding its political and institutional frameworks is low, Fitch cut again in December 2009 its credit rating to "BBB+". Other international rating agencies have followed Fitch's initiatives. For instance, Standard & Poor's has cut its credit ratings for the bonds exported by Greece from "A-" to "BBB+". Moody's has also taken similar actions by reducing Greece's credit ratings from "A2" to "A1".

In 2001 when Greece joined the Euro zone, it 101,5% public debt to GDP was already high and over the years, it has not managed to lower it to the 60% limit. Thanks to low level of interest rates, Greece has managed to finance its public debt under convenient conditions. Low interest rates encouraged the expenditures and enable the economy to grow at an average of 4% in 2008. Moreover since the GDP was high, the ratio of public debt regarding to national revenue remained low and to some extent this prevented the structural weakness of the financial equilibrium from being discovered.

The Greek government submitted on the 15th January its Stability Programme to the European Commission containing the exit measures envisaged in overcoming this crisis

situation. In this Programme, the Greek government expressed its aim of reducing this year the public deficit by 4 percentage points down to 8,7% of GDP. It also aims to reduce the public deficit thereafter to 5,8% in 2011, to 2,8% in 2012 and 2% in 2013. For this purpose, the expenditures will be limited and tax revenues will be increased. Among the other measures proposed within this Stability Programme are the following: the rise of duties on fuel products, the raise of the retirement age, the reduction of public expenditures, no increase in the wages of civil servants including the Prime Minister and Deputies for the year 2010, no recruitment and set a ceiling to salaries. The European Commission and the EU leaders have announced their support for the Stability Programme presented by the Greek government. However they consider it necessary to apply strict supervision in order to ensure the efficient implementation of the plan. Moreover, in its evaluation report, the European Commission presented some additional suggestions to reach the goal of reducing public deficit. Within this framework, the European Commission requested from the Greek government to implement further structural reforms that will improve the efficiency of the public administration as well as some reforms in the social security and health sectors. The Commission has also stressed that the conditions on labour market should be improved and that financial and banking sectors should be stabilized. Greece is also expected to restructure the public financial administration and its supervision in order to improve its efficiency and transparency. On the other hand, it has been observed that social security expenditures constitute a considerably high share of the country's budget compared to other EU countries. Moreover with its ageing population, it becomes more than ever indispensable for Greece to restructure its social security system in order to spread its public debts in the long term. It is also pointed out that the expenditures realized in the health sector should be better scrutinized.

Greece has been under pressure for a long time because of its budgetary deficit. However the only concern for the European Union is not only to bail Greece out but also to prevent that the market disturbance spreads to other countries such as Spain, Portugal and Ireland. Along with Greece, other countries of the eurozone had to increase their public expenditures in order to deal with the economic recession following the global financial crisis. As a result, their budgetary deficits and public debts have significantly increased. According to the latest data published by Eurostat, the last year's public deficit was 12,7% of GDP last year in Spain, 12,5% in Ireland, 8,3% in France and 8% in Portugal. The public debt-to-GDP ratio is also high in these countries (77,4% in Portugal, 65,8% in Ireland, 76,1% in France, 114,6% in Italy).

Greece's difficulties and the stability measures announced led the Euro to lose its value on the financial markets. Furthermore, other countries in the European Union and in the eurozone have registered similar problems in terms of public debt and deficit. Although the gravity of the situation is not comparable to Greece, this negatively affects the markets and, as a result, for the first time in nine months, the Dollar has risen against the Euro.

With the accession to the eurozone, Greece had to comply with the Maastricht criteria. Therefore the Greek government does not anymore have the authority neither to devaluate its currency nor to reduce the level of its interest rates to ease the pressure exercised on the debt. The level of interest rates is nowadays determined by the European Central Bank on behalf of the Euro zone countries. It will not be easy for Greece to follow strict monetary and fiscal policies in order to get the economy back on the tracks. Besides this, these policies could lead to some strong reactions from the public and create a risk of social unrest within the country.

Germany, the biggest economy of the European Union and the eurozone, does not approve the transfer of additional resources to countries which do not respect the budgetary discipline. In this case, Greece would be rescued by the European Union. Ireland, Portugal and Spain which have the similar problems might be next in line. Therefore there are some concerns that these countries might be more tempted to diverge from the budget discipline once they will be ensured to get some assistance.

On the other hand, Germany and France, the richest countries of the European Union are concerned about their financial markets since their banks have financial claims not only from Greece but also from Spain, Ireland and Portugal. Therefore in case there were impacts of Greece's debt crisis on other EU countries, the French and German banking sector would be deeply affected. As a result, this will worsen the overall debt situation. The losses of the countries that have stocks and shares and excessive loans of the countries having financial problems will disturb the whole financial system of the European Union.

The Economic and Financial Ministers of the European Union gathered on the 15th and 16th February and gave in accordance with the European Commission their opinion on the Stability Program presented by Greece with the aim to reduce its public deficit to 3% of GDP by 2012. Within this framework, they requested from the Greek government to establish a timetable for the implementations of these measures. Furthermore it has been decided that there should be a revaluation of these measures in the middle of the next month and in case the European Commission considers it necessary, Greece will be asked to take some additional measures. By establishing a special supervision system, the Council will monitor whether Greece is respecting or not its commitments. Greece will have to submit its first report to the European Commission by 26th March. From this date on, Greece will have to present every three months an updated report regarding its commitments from the Stability Programme. During the next Summit of Economic and Financial Minister of the European Union which will be held on the 15th and 16th March, Greece's economic situation will be analyzed and it will be decided whether further measures should be taken.

Since it has been discovered that Greece had faked its economic indicators in order to enter the eurozone while not fulfilling the necessary criteria, the European Commission is taking the necessary actions to give Eurostat the authority to verify the data released by Member States. This shows that the European Commission wants to monitor Greece closely from now on. Greece, which has lost its credibility through fraudulent practices, is now confronted with a new issue. After joining the eurozone in 2001, Greece has used a complex swap system with the help of the intermediary international financial institute Goldman Sachs in order to supply the country with an important amount of foreign currency. This reveals that Greece by hiding its debts managed to keep its public debt under the limits allowed by the Stability and Growth Pact while it has been spending more than it could afford. During the last Summit of the Economic and Financial Ministers, which aimed to clarify the situation, it has just been realized that other countries might have used the same practice. At the present time, no data is available to confirm these suspicions. Nevertheless it has been expressed that credit swap operations in financial market should be carried out with more transparently. Therefore further action should be taken to strengthen the supervision at EU level.

In this last period, Greece is referred as the EU's "sick man". The Greek case has shown that there is the need for better coordination of the economic and financial policies of the European Union. It has also been an important test regarding for the existing supervision mechanisms. As it has been mentioned by the Luxembourg's Prime Minister and the

President of the Eurogroup, Jean-Claude Juncker, in order for a region using a common currency to maintain its sustainability, it is essential to prevent gaps among Member States' balance of payments in the long run.

The Heads of State and Government reaffirmed on the first day of the European Council held on 25-26 March that all eurozone members must carry out sound national policies in line with the agreed rules and that they should be aware of their shared responsibility for the economic and financial stability within the area. They also fully supported the efforts made by the Greek government and welcomed the additional measures announced on the 3rd March. They found the measures sufficient to preserve the 2010 budgetary targets. Eurozone member states confirmed their willingness to take determined and coordinated action for maintaining the financial stability in the Euro Area as a whole, as decided on the 11th of February.

On the Council's meeting, the countries of the Eurozone agreed in detail the conditions of the aid package to Greece. It consists of a combination of substantial International Monetary Fund financing and a majority of European financing that comes from the Eurozone member states' voluntary contribution in the form of bilateral loans. The mechanism, complementing International Monetary Fund financing, has to be considered *ultima ratio*, namely, the Eurozone mechanism for providing bilateral loans would be invoked only as a last resort that is to say in the case Greece would be unable to sell new bonds on the markets. Disbursement on bilateral loans would be decided by the member states of the Eurozone by unanimity and would not only be subject to strong conditionality but also based on an assessment from the European Commission and the European Central Bank. If it is decided to grant a loan, then the amount provided by each Eurozone country will be in line with their capital share in the European Central Bank (ECB). The mechanism is not to provide financing at average Eurozone interest rates, the objective is to set incentives to return to market financing as soon as possible by adequate risk pricing. Decisions under this mechanism will be taken in full consistency with the Treaty framework and national laws.

The debt amount of Greece has reached €300 billionand the country's loans to be refinanced during April and May are around 20 billion and 25 billion Euros. But it is expected that Greece should first seek financing from the bond markets.

Germany's chancellor Angela Merkel, had initially opposed to a European aid plan for Greece on the grounds that German taxpayers' money were being used to bail out Greece. Finally leaders agreed on a European aid plan for emergency loans. Merkel noted that the Eurozone countries will not allow Euro to be destabilised.

Any decision to activate the support mechanism has not been taken on the last Heads of State and Government Council due to the fact that Greek government has not requested any financial support. But Greece's Prime Minister George Papandreou welcomed the deal reached by the 16 countries for bilateral loans from Eurozone and the International Monetary Fund. He said he hoped they would never need to use this mechanism, but the fact that it was there was a very positive signal for restoring the credibility of the country.