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### THE RECENT GREEK CRISIS: HARBINGER OF A NEW CONTAGION?

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As the global financial system has yet to recover from the subprime mortgage crisis of 2008, the recent financial crisis in Greece is feared to ignite a new contagion of downturn, which might affect Spain, Portugal, Italy, and Ireland at the outset. The question is: “Will Greece be the Bear Stearns<sup>1</sup> of 2010?”

The concerns of possible contagion are not meritless, given the high spread of the financial crisis of 2008. As known, the subprime financial crisis that started in the United States spread quickly, affecting the entire U.S. financial system and other financial markets, from stock markets and real estate, to currency and primary commodity markets.<sup>2</sup> This widespread crisis required an unprecedented global response. Starting with the U.S. regulatory authorities, national governments and multinational organizations instituted their solutions to the crisis.

#### I. A PREDICTABLE CRISIS?

Like the global financial crisis of 2008, the Greek crisis did not come like a bolt from the blue. Years of unrestrained spending, cheap lending, and failure to implement financial reforms badly struck Greece when the global financial system had already been gloomy for two years.<sup>3</sup> The new Greek administration inherited, in 2009, a deficit of at least 12.7% of the gross domestic product (GDP), whereas the previous government claimed that it was only 3.7% of the GDP,<sup>4</sup> which would have been in line with the Maastricht criteria.<sup>5</sup> “Now, the new government in Athens has admitted that Greece [only] met the [European Union’s] financial admission standards by falsifying its books.”<sup>6</sup> This raises the question as to whether Greece’s admission to the Union in 1981 was too hastily decided, as the country “remains equally unready today.”<sup>7</sup>

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<sup>1</sup> In June 2007, Bear Stearns Companies pledged up to \$3.2 billion in loans to bail out one of its hedge funds that was collapsing due to bad bets on subprime mortgages. The near collapse of two hedge funds managed by Bear Stearns is seen as the beginning of the global financial crisis. Federal Reserve Bank of New York, *Financial Turmoil Timeline*, [http://www.newyorkfed.org/research/global\\_economy/Crisis\\_Timeline.pdf](http://www.newyorkfed.org/research/global_economy/Crisis_Timeline.pdf); Julie Creswell & Vikas Bajaj, *\$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES, June 23, 2007.

<sup>2</sup> United Nations Conference on Trade and Development, Geneva, Switz., *Trade and Development Report 2009*, at 1, available at [http://www.unctad.org/en/docs/tdr2009overview\\_en.pdf](http://www.unctad.org/en/docs/tdr2009overview_en.pdf).

<sup>3</sup> Q&A: *Greece's Financial Crisis Explained*, CNN, Feb. 14, 2010, <http://www.cnn.com/2010/BUSINESS/02/10/greek.debt.qanda/index.html>.

<sup>4</sup> Eric Margolis, *Cleaning up Greece's Augean Stable*, HUFFINGTON POST, Feb. 24, 2010, [http://www.huffingtonpost.com/eric-margolis/cleaning-up-greeces-augea\\_b\\_474730.html](http://www.huffingtonpost.com/eric-margolis/cleaning-up-greeces-augea_b_474730.html).

<sup>5</sup> Protocol on the Excessive Deficit Procedure, Treaty on European Union, art. 104c(2), Feb. 7, 1992, 1992 O.J. (C 191) 13 [hereinafter E.U. Treaty].

<sup>6</sup> Margolis, *supra* note 4.

<sup>7</sup> *Id.*

## II. RESPONSES TO THE CRISIS

The Greek government has already taken some precautions to combat the crisis. Within the framework of its Stability and Growth Program, Greece proposes to cut its overspending to under 3% of the GDP in 2012 through freezes of public sector remuneration and recruitment, combined with increases in both tax collection and retirement ages. However, E.U. authorities have expressed doubts that Greece will be able to meet all its targets.<sup>8</sup>

However, under the current E.U. legislation, there is no bail-out mechanism to be implemented by the Union (Articles 104<sup>9</sup> and 104b<sup>10</sup> of the E.U. Treaty), lest there might arise potential problems of moral hazard. That is a particular concern of the larger European economies, such as Germany, which fear that they would ultimately carry the burden of rescuing some of the fiscally irresponsible members. While Article 103a<sup>11</sup> may be used by the European Council to assist a Member State that is “seriously threatened with severe difficulties caused by exceptional occurrences beyond its control,” it is obvious that Greece’s deficit cannot qualify as an exceptional occurrence.

Other possibilities seem neither very appealing nor easy to implement: reduction of the deficit from 13% to 3% of the GDP within just three years; outright default on all or part of the Greek government’s debt; or some kind of bail-out led by Berlin and Paris.<sup>12</sup> Abandoning the euro

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<sup>8</sup> Nicholas Paphitis, *Greek PM Meets Deutsche Bank Chief on Crisis*, BUSINESS WEEK, Feb. 26, 2010, available at <http://www.businessweek.com/ap/financialnews/D9E44I081.htm>; Vanessa Rossi & Rodrigo Delgado Aguilera, *No Painless Solution to Greece’s Debt Crisis*, Chatham House Programme Paper IE PP 2010/03, <http://www.chathamhouse.org.uk/publications/papers/view/-/id/833/>.

<sup>9</sup> The first paragraph of Article 104 of the E.U. Treaty is as follows:

Overdraft facilities or any other type of credit facility with the ECB [European Central Bank] or with the central banks of the Member States (hereinafter referred to as “national central banks”) in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

<sup>10</sup> The first paragraph of Article 104b of the E.U. Treaty is as follows:

The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

<sup>11</sup> Article 103a of the E.U. Treaty is as follows:

1. Without prejudice to any other procedures provided for in this Treaty, the Council may, acting unanimously on a proposal from the Commission, decide upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products.

2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, the Council may, acting unanimously on a proposal from the Commission, grant, under certain conditions, Community financial assistance to the Member State concerned. Where the severe difficulties are caused by natural disasters, the Council shall act by qualified majority. The President of the Council shall inform the European Parliament of the decision taken.

<sup>12</sup> Niall Ferguson, *A Greek Crisis is Coming to America*, FIN. TIMES, Feb. 10, 2010, available at <http://www.ft.com/cms/s/0/f90bca10-1679-11df-bf44-00144feab49a.html>.

would not be a very good solution either, with the risks far exceeding the likely benefits and the legal implications being severe.<sup>13</sup>

As was witnessed during the global financial crisis, rescue or bailout plans would likely raise the issue of moral hazard. It is known that four other countries—Spain, Portugal, Ireland, and Italy—are facing similar issues. Any rescue plan with lenient terms might therefore cause these countries to lose the incentive to resolve their own problems. On the other hand, if a loan bailout is implemented with harsh measures that would eliminate moral hazard, it could do significant damage to local economies, especially already-fragile domestic banks.<sup>14</sup>

After long debate as to how to combat the crisis, the International Monetary Fund (IMF), the Commission, and the European Central Bank (ECB) finally committed to provide Greece with a financing package of €110 billion (about \$145 billion).<sup>15</sup>

### III. ONCE AGAIN, ALL EYES ON DERIVATIVES

The swap market, particularly that of credit derivatives, has seen increased attention as a result of the credit crisis. The interconnectedness of the financial system through credit derivatives is seen as a significant source of credit risk. In the past, it required the bailout or rescue of some major financial institutions like American International Group.<sup>16</sup> The concerns about swap agreements have taken center stage during the Greek crisis.

Greece made a huge deal with Goldman Sachs in 2002 for cross-currency swaps in which government debt issued in dollars and yen was swapped for euro debt for a certain period, to be exchanged back into the original currencies at a later date. These transactions are not contrary to the current E.U. rules per se, as they are actually part of normal government refinancing. However, in the Greek case the bankers created a special kind of swap with fictional exchange rates. That enabled Greece to receive a far higher sum than the actual euro market value of ten billion dollars or yen. In that way Goldman Sachs managed to arrange an additional credit of up to one billion dollars for the Greek government. This credit, disguised as a swap, did not appear in the Greek debt statistics.<sup>17</sup>

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<sup>13</sup> Rossi & Aguilera, *supra* note 6.

<sup>14</sup> Tom Lauricella, *Greek Deal Stirs Moral Hazard Concerns*, WALL ST. J., Feb. 11, 2010.

<sup>15</sup> The IMF's support will be provided under a three-year €30 billion (about \$40 billion) stand-by arrangement. In addition, euro area members have pledged a total of €80 billion (about \$105 billion) in bilateral loans to support Greece's effort to get its economy back on track. Implementation of the program will be monitored by the IMF through quarterly reviews. IMF Survey, Europe and IMF Agree €110 Billion Financing Plan with Greece (May 2, 2010), <http://www.imf.org/external/pubs/ft/survey/so/2010/CAR050210A.htm>. The IMF previously offered Greece only expertise and support when it was deemed necessary. Press Release, International Monetary Fund, IMF Statement on Greece (Feb. 11, 2010), <http://www.imf.org/external/np/sec/pr/2010/pr1031.htm>; David Hawley, Senior Advisor of IMF External Relations Department, Press Briefing (Feb. 18, 2010), <http://www.imf.org/external/np/tr/2010/tr021810.htm>.

<sup>16</sup> HAL S. SCOTT, INTERNATIONAL FINANCE TRANSACTIONS, POLICY AND REGULATION 764 (16th ed. 2009).

<sup>17</sup> Beat Balzli, *How Goldman Sachs Helped Greece to Mask its True Debt*, SPIEGEL, Feb. 8, 2010, <http://www.spiegel.de/international/europe/0,1518,676634,00.html>.

Ben S. Bernanke, Federal Reserve Chairman, said the U.S. Central Bank is reviewing derivatives contracts arranged between Goldman Sachs Group, Inc. and investment banks with Greece.<sup>18</sup> It remains to be seen if, in the near future, E.U. officials will amend their legislation to crack down on swap transactions that might be used to mask real financial situations.

Whatever the consequences, the Greek crisis is perceived as a serious threat, not only to the E.U. financial system, but also to the global financial system. The European Union is a huge market, a laboratory for international regulation. E.U. developments are therefore important to international financing.<sup>19</sup> Whatever the solution to a financial crisis is, one thing remains for sure. The bailouts and other rescue packages, after all the damage is done, are not the best answer. The global financial economy needs stringent supervision and oversight, both on a national and international level, as the Greek example dictates. The role of the national authorities to supervise their institutions and to cooperate with each other is especially crucial, because, due to the interconnectedness of the financial markets, no financial problem remains purely a national issue. A well-working financial system, with all the control mechanisms in place, is necessary for growth. In addition, Greece and other countries should implement a sane financial system that will boost economic growth, also taking into consideration the needs of their citizens and implementing social welfare policies. As the Greek case demonstrates, at the end of the day, these are the citizens who pay for the loose financial policies and fiscal irresponsibilities of the administrations.

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<sup>18</sup> Craig Torres, *Bernanke Says Fed Reviewing Goldman Sachs-Greece Contracts*, BUSINESSWEEK, Feb. 26, 2010.

<sup>19</sup> SCOTT, *supra* note 16, at 272.