Chapter 2
What solidarity in the Eurozone after the Greek crisis of 2015?

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Introduction

The first semester of 2015 marked the latest episode in the Greek Euro crisis which began in 2010. The beginning of the crisis itself – Greek chronic policy failures prior to it notwithstanding – was a consequence of the incompleteness of the monetary union in Europe. The fact that the Eurozone reached once again a critical point in 2015, faced as it was with the possibility of a Greek exit ('Grexit'), was, however, the outcome of an ineffective approach in the way that the Greek debt crisis had been handled since 2010. It also resulted from the unwillingness of the policy actors who committed mistakes to admit these, and change course. The Euro crisis exposed divisions among and even within Member States, and not merely along simple lines such as creditors vs. debtors. Indeed, the crisis also brought to the fore very clearly the fact that the European Central Bank (ECB) has been crossing the limits of its political independence. The ECB turned into a decisive pressure lever for steering Member States that need it to function as a lender of last resort (either to their banks or to their sovereign) in certain policy directions that are preferred by some or most creditor Member States.

In 2015, five years after the onset of the Eurozone crisis, there was no shortage of analyses as to the causes of the crisis and what needed to be done – not just to end it but also to defend the Eurozone against future shocks. While there was no across-the-board agreement on the exact solutions, one common feature of the tabled proposals (even those that were not very ambitious) was the need for more inter-state solidarity in the form of pooling together collective resources to deal with certain shocks. If the latest episode of the Greek Euro crisis demonstrated something, it was that the appetite for inter-state solidarity remains very low.

This chapter first spells out the context in which the 2015 Greek crisis can be viewed: as a division of interests between (creditor and debtor) Member States and the ECB. It shows how, in a context of intergovernmental decision-making, the Greek crisis aggravated these divisions. It then argues that given the lack of appetite for inter-state solidarity, it is important to increase the scope for solidarity at the national level. According to this view, the burden that has been put on national fiscal policies by the Eurozone's fiscal rules, the incomplete banking union and the European Central Bank's strategic behavior have to be seriously mitigated. Although fiscal policy coordination – and therefore rules on national fiscal policies – are necessary their focus has to shift in favour of allowing stabilization to take place at the national and aggregate level, and away from the focus on moral hazard. The banking union has to be completed with a deposit insurance and a more potent single resolution fund. This would require some pooling of fiscal resources, even if it would certainly fall short of a 'fiscal union'. Last but not least, collective bargaining institutions have to be strengthened at the national level while initiatives need to be taken in view of their coordination across national borders and fiscal policies within the Eurozone.

1. Power asymmetries in decision making and the notion of inter-state solidarity in the Eurozone

To understand what we can learn from the latest episode of the Greek Euro crisis in 2015 regarding the possibility of a more solidaristic governance in the Eurozone, two points need to be addressed. First, there are still very different views on what 'inter-state solidarity' should mean in practice, and under what conditions it should be demonstrated in the Eurozone. Given that, it is then not surprising that the governance of EMU has been expanding in scope, but not by transferring competences to supranational institutions other than the ECB (cf. Bickerton 2015b; Bickerton *et al.* 2015). The fact that decisions on economic policies in the Eurozone are predominantly taken by intergovernmental institutions like the Euro summit and the Euro group has meant that in shaping policies and crisis responses, national interests have been pitched against each other. Given that decisions on actions of inter-state solidarity have also been taken on an intergovernmental basis, the balance of power within the intergovernmental decision bodies, with the crucial help of the ECB, has tilted decisively in favour of the creditor Member States' interests and ideas in general, and those of Germany in particular (De Grauwe 2013a; 2013b and 2015).

When it became apparent in early 2010 that the Greek government had all but lost its access to sovereign bond markets, there were two options: either to let the Greek government default in the face of mounting pressure from the financial markets, in the form of ever higher interest rates at which it could borrow; or to provide it with liquidity support so as to allow it to keep servicing its debt, to reduce its financing needs (i.e. bring down its budget deficit) more gradually and eventually regain access in the markets at an interest rate it could afford. The Eurozone leaders were caught unprepared, as the fiscal rules and the markets were supposed to have prevented such an event from occurring. But eventually they opted for a Greek bailing-out.

This wisdom of that choice has ever since been the subject of a heated debate. The crux of the disagreement between those who think the bail-out was a formidable mistake and those who think that it was, in retrospect, a fairly reasonable thing to do, is that Greece's public debt was already unsustainable in 2010. The bail-out thus meant that more debt was added to a debt that the country's taxpayers were already unable to pay. However, given that the European economies had barely started to recover from the turmoil caused by the financial crisis of 2008-2009 – a crisis that had been sparked by the bankruptcy of Lehmann Brothers – there was the risk that a Greek sovereign debt default would trigger a systemic crisis in the financial markets, more particularly in the Eurozone. These fears were underpinned by the fact that 72% of the Greek public debt was held by non-residents (Bruegel database of sovereign bond holdings developped in Merler and Pisani-Ferry 2012). Just as importantly, the ECB had not yet fully and unreservedly assumed its role as lender of last resort for sovereigns in the Eurozone. This meant that in the event of any signs of contagion to other vulnerable Member States, sufficient support of the ECB could not be counted on (Davies 2015b).

For the purposes of this chapter, the answer to whether the bailout was justified or not is not crucial. What is important, however, is that both options were on the table and that the bail-out option was presented as 'solidarity' with Greece. If Greece had been allowed to default, then many of its creditors would have experienced a loss of assets. The holders of Greek government bonds were indeed financial institutions (banks) in Greece and abroad but also institutional investors, for example pension funds, especially in Greece. Tracing the ownership of sovereign bonds once they have started trading on the secondary market is fraught with difficulties. However, there are reasons to assume that a default would have eroded the capital adequacy of certain banks, in particular in Germany and France. Although the size of the problem for foreign banks has been arguably overstated in popular analyses (cf. Whelan 2015a)[1], it is fair to say that the problems that creditors might have faced from a Greek default would have been dealt with by their own national governments. In that respect, the consequences of an unsustainable public debt would have been shared between Greece and its creditors.

It should be noted that this default option would not in any way have constituted a 'charitable' approach, as for every irresponsible borrower (the Greek government in this case) there have been irresponsible lenders. In the case of Greece, even the forged (as it turned out in 2009) statistics on its public finances suggested that the country's public finances were not healthy, or well managed, even before 2009.

Some observers have argued that allowing Greece to default in 2010 would have constituted a 'humiliation' of a European government by the financial markets: the latter would have essentially forced Greece into not honouring its obligations, with all the reputational damage this would have implied. Markets would have triumphed over politics. That was an option that France and other southern European members opposed, arguing instead that fellow Member States should show 'solidarity' to the Greek government, and collectively help shore it up

1. Davies (2015a) provides data on the amount of Greek government bonds but also of deposits held by German and French banks in 2010. According to his calculations, a Greek sovereign default would have been a 'deep wound in the flesh' for them but, unlike with Greek banks, it would have been nowhere near wiping them out.

against the pressure of the markets. This surge of 'solidarity' was not entirely altruistic. French but also German banks had some of the highest exposures to Greek public debt[2]. Other southern European Member States, such as Portugal, Spain and Italy, feared the potentially grave knock-on effects from a Greek default, as they had already started feeling the rising pressure on the interest rates at which their governments could borrow in the sovereign debt markets (Sandbu 2015: 56).

From the perspective of Greece, it was not clear whether defaulting would necessarily imply leaving the Eurozone. Despite popular perceptions, there is no 'default prohibition' rule in any of the European Treaties. The only reason for which a default on part or all of its public debt could lead to an exit from the Euro would be that the ECB might not provide liquidity support to the Greek banking system in its aftermath. The prospect of a sovereign default was indeed likely to trigger a bank-run, with depositors massively withdrawing their deposits from Greek banks, which would then find themselves with insufficient liquidity for performing their functions. In Member States with their own central bank, such a bank-run can be quelled by the central bank which would announce that it will provide as much liquidity as necessary to the banking system. The ECB in 2010 was reluctant to play that role.

Even if the liquidity crisis was averted, the fact remains that Greek banks were relatively large holders of national public debt (bonds) and default would harm the assets side of their balance sheets. They would then need to be recapitalized, a function which in 2010 and in the absence of a banking union or the ESM would have to be performed by the Greek government: the latter would issue bonds to hand over to the banks as assets. The ECB could then refuse to accept such bonds as collateral for providing liquidity to the Greek banks. In this case, the Greek government would have a choice between declaring a prolonged bank holiday, which would cause the equivalent of a cardiac arrest to the Greek economy, or starting to print its own currency, thus effectively exiting the Eurozone. In that respect, and since Greek public opinion

2. Although there is always a margin of error in deciphering who owns government bonds, Dan Davies (2015a), based on data from the Bank of International Settlements (BIS), provided a rough estimation of 27 billion euros held by French and 25 billion euros by German banks in early 2010.

was firmly in favour of Greece's continued membership of the Euro, the bail-out, insofar as it averted Greece from abandoning the Euro, was indeed a manifestation of 'solidarity' albeit not an optimal one.

For 'solidarity' to be shown through a bail-out, a collective financing solution would have to be found, since there were objections to the option of bringing in the IMF to deal with the Greek crisis on several grounds, mostly notional rather than factual[3]. Given the principle of proportional participation, collective financing would make Germany the largest contributor. The problem was, however, that since the inception of the monetary union in Europe, Germany has been adamantly against the establishment of a 'transfer union'. This is why the only way that Germany would agree to showing solidarity and providing financial support to Greece would be on the condition that far-reaching policy changes and adjustment would take place. This would ensure that no 'blank cheque' would be given to the Greek government, but also that support would never be needed again. Last but not least, Germany was an important factor in determining the amount of money committed to the bail-out package(s). That amount, in turn, determined how far austerity would have to go, after the various financing needs – (including debt servicing and bank recapitalization funding) – had been taken into account.

It has been well documented that the policies imposed as conditions for receiving the financial aid packages in Greece have ultimately been very harmful for its economy (see for example, Gechert and Rannenberg 2015). A central pillar of these policies was fiscal austerity in order to bring down the government budget deficit. It is plausible that if more

3. Two notional (rather than factual) reasons have been put forward for the involvement of the IMF in addition to the Eurozone. First, Germany wanted to avoid making the Greek 'rescue' look like a bail-out, as there was the interpretation that the Treaty forbids bail-outs. This is, however, not self-evident. As Whelan (2015a) argues, art. 125 of the current Treaty mentions that the EU and its Member States will not be liable for or assume the commitments of other countries. Providing loans to other countries so that they can roll their own debts over is not assuming liability. Moreover, and similarly to the 'financial markets humiliate Eurozone government' argument, some in the Eurozone would perceive it as a sign of weakness, if not humiliating, to bring in the IMF alone: it would signal that the Eurozone could not take care of its own problem. Otherwise, the IMF involvement would have been welcome in order to provide their knowhow and experience in dealing with balance of payments/sovereign debt crises. In the end, however, the IMF had to make political compromises with the Eurozone in handling the situation in Greece, which led it to compromise the principles under which it normally organizes its interventions in troubled countries.

consideration had been given to pursuing a slower pace of fiscal austerity (that is, to 'budget financing'), the amounts committed to other financing needs could have been smaller (cf. Davies 2015b). After all, the Greek banks' balance sheets have suffered from the collapse of the real economy and the non-performing loans that it accumulated to their balance sheets. Moreover, Greece's difficulties in returning to the sovereign debt markets have to a large extent been shaped by the ongoing crisis. However, this sort of 'Keynesian' thinking has, to put it mildly, not been predominant in German and EU economic policy cycles.

The unprecedented size of the first bail-out package to Greece (110 billion euros), and the ex-ante heroic assumptions on which the success[4] of its attached Economic Adjustment Programme relied (Theodoropoulou and Watt 2015), meant that there were serious risks of a default anyway. These risks and the casting of the Greek crisis as a problem with entirely Greek origins meant that a very tight incentive structure would have to be created for Greece, for the package to gain approval by the national parliaments of the creditor Member States. Thus the Troika was born, as the 'technocratic' agent of the lenders (Pisani-Ferry *et al.* 2013) and agreement was reached that the earmarked funds would be disbursed in quarterly installments following tight ex-ante and ex-post controls of compliance with imposed policy plans (Theodoropoulou 2014).

The role of the Troika evaluations in putting pressure on the Greek government was enforced by the European Central Bank, the only institution that could effectively force a Member State to abandon the single currency and start reprinting its own currency. The ECB has been a catalyst for the dominance of creditor Member States' preferences in policy choices, by making its support (as a lender of last resort to banks and sovereigns in the Eurozone) conditional on borrower countries reaching an agreement with effectively the Eurogroup. This is an important development insofar as it indicates what Whelan termed as 'politicised mission creep' by the ECB (Whelan 2015c).

4. The success of the programme was defined as the return of Greece to the financial markets.

In short, the absence of a banking union and the conditional and initially reluctant role of the ECB as a lender of last resort to banks and sovereigns made Member States in trouble vulnerable and increased their reliance on financing from the rest of the Eurozone. As decisions on this support were reached on an intergovernmental basis, the Member States that contributed (the 'creditors') were in a more powerful position than the debtors. Through their decisions – for example on how much financing would be made available – the creditors could shape how fast fiscal adjustment would have to take place in bailed-out Member States, notably via the budget constraint of the support package.

2. Greece and the Eurozone on the brink: the 2015 surrender

2.1 The road to the January 2015 elections

By late 2014, having overseen the implementation of most of the Economic Adjustment Programme that was a condition for receiving the second bail-out, the grand coalition government between the weakened centre-right New Democracy (ND) and the almost evaporated centre-left PASOK failed to reach an agreement with the Troika[5] on the fifth and final ex-ante assessment of the second bail-out programme. This assessment, the successful conclusion of which was necessary for Greece to receive the final tranche of funding (7.2 billion euros) from the second bail-out programme, had been pending since the autumn of 2014.

The friction point between the Troika and the government – in office since the general elections of June 2012 and with demonstrable signs of fiscal consolidation and reform fatigue – was the further fiscal tightening of around 1 billion euros that would have been necessary in order to close the projected gap in the budget. To make figures add up, the government would have had to legislate further pension cuts and tax increases, which then-prime minister Samaras estimated would not be voted through by the Parliament. Since April 2014, the Greek govern-

5. European Commission, European Central Bank and International Monetary Fund.

ment had been expecting the Eurozone leaders to open discussions on further debt relief to Greece, as they had promised, in late 2012, to do once the Greek government achieved a balanced budget (which it did in early 2014). The government could have used this relief to make the further cuts more palatable to Greek public opinion.

However, this discussion on debt relief was postponed without any indication by the lenders as to when it might start. The almost certainty of a forthcoming electoral victory of SYRIZA, a radical left, anti-systemic party (cf. Pappas 2014) in the next general election created incentives for the lenders to neither conclude the agreement nor commit to any debt relief, for fear that a SYRIZA-led government would have no incentive to stick to agreed measures once funding had been released and debt relieved (Varvitsioti and Telloglou 2015). Moreover, the second bail-out programme was due to expire at the end of February 2015. Greece was facing large loan repayments for 2015. Without the official financing from the bail-out, it was certain that it would not be able to honour at least some of them, including to the ECB and the IMF.

The stalling of negotiations over the assessment of the second Economic Adjustment Programme illustrates the tension between the needs of Greece (requesting some flexibility in the policies it had to pursue) and the insistence of the creditors' agents that conditions had to be fulfilled *before* support could be provided. All this while evidence (e.g. Gechert and Rannenberg 2015) suggested that the imposed conditions were actually undermining (a) the goal of getting the Greek economy to grow again and (b) the likelihood that Greece would no longer need financial support, and even be able to pay back its debts. In late 2014, this insistence did not even recede when faced with the possibility that the grand coalition government in Greece, which was led by a party from the EPP family and an ally of other creditor governments in the Eurozone, would collapse.

By the end of 2014, Greece had managed to balance its primary government budget, from a deficit of 10% of GDP in 2009, and this amidst the worst recession the country had experienced in the postwar era. In practice, that meant that government revenues were sufficient to cover government expenditure, excluding interest. This was a positive development insofar as it implied that Greece would no longer rely on its creditors in order to finance its current expenditure needs. From that point onwards, budget surpluses would be used to service the existing debt, of which 80% was official – that is, held by other governments and supranational/intergovernmental institutions. In other words, the fiscal surpluses that Greece would have to produce by means of fiscal austerity in a context of a weak economy would be requested so as to transfer resources (that is, pay interest and capital) to its creditors, since the government's own expenses were in principle covered by its revenues.

Moreover, Greece had managed to reduce its current account deficit from a staggering 16% of GDP in 2008 to just below 3% in 2014, which meant a large reduction in its financing needs for transactions with the rest of the world. This adjustment had come mostly through lower imports rather than through higher real exports, indicating a domestic demand repression effect (Theodoropoulou 2016). Last but not least, and contrary to popular accounts in Northern Europe, Greece had undertaken a large number of structural reforms in the labour market (see for example, OECD 2015), although more was left to be done in other critical areas.

These adjustments had, however, taken place at a very high price. Between 2008 and 2014, the Greek economy lost 25% of its real output. In 2014, tax revenue was below target to the tune of 1.3 billion euros, with indirect taxes undershooting the target figure by 500 million euros due to lower than forecasted transaction taxes. At the same time, the stock of unpaid taxes rose by 13.8 billion in 2014 to reach a total of 73.8 billion euros that year (Mouzakis 2016). The average unemployment rate peaked at over 27% of the labour force in 2013. Although youth unemployment rates – at nearly 60% – were the figures most often read about in the headlines, most job losses had actually affected men of 40 years and above, whose unemployment rates had increased 4-5-fold, depending on the age group and sector (Theodoropoulou 2016) .

Nevertheless, by the end of 2014, there were some indications that the worst might have been over. Greece had taken a fiscal policy stance of slight expansion. In its Autumn 2014 forecasts, the European Commission had, for the first time since 2009, predicted that the Greek economy would register a slightly positive growth rate in real output of 0.6% for 2014, and a brisk 2.9% was projected for 2015. The unemployment rate was expected to stabilize in 2014 and slowly start declining after that. The gross public debt/GDP ratio was also expected to stabilize at the high level of 175% and start declining from 2015 onwards, as the headline government budget balance was also expected to turn into a surplus. In other words, by late 2014, the Greek economy appeared to have dealt with the macroeconomic imbalances that triggered its crisis, but it also had serious wounds to heal from that process.

The dead end to which the negotiations with the Troika had led, the constitutional requirements for the election of a new President of the Republic and a gamble that Prime Minister Samaras decided to take, resulted in the calling of a general election for 25th January 2015. It would be the third election since 2010, when the first package of financial support to the Greek government was received.

2.2 'Hope is coming': the ascent of SYRIZA to government

SYRIZA, which had gained a modest 5% of the vote in 2009, campaigned for the January 2015 elections on the promise that it would scrap austerity, eliminate the Troika and embark on a programme of financial support to those hardest-hit by the crisis: the so-called 'Thessaloniki programme' (SYRIZA 2014). The motto of the SYRIZA electoral campaign was that 'Hope is coming'. At the same time, the party's Eurosceptic rhetoric had been clearly toned down since 2012, when its strong potential for winning office became apparent. Early declarations that membership of the Euro would not be a 'taboo' for SYRIZA had been replaced with a 'third way' option, combining Euro membership with less harsh policies and less intrusiveness in policy making (Mudde 2015). In January 2015, SYRIZA won an even larger victory than forecasted by the polls, with 36% of the votes. It came just two seats short of an absolute majority in the Parliament. This result confirmed the collapse of power of the two parties (PASOK and ND) that had governed Greece since its return to democracy in 1974. The night of the 2015 elections, SYRIZA's president Alexis Tsipras, announced that his party would form a government with the small ultra-right wing (populist and nationalist) party of Independent Greeks (ANEL). Between them, the two parties held 162 of the 300 Parliament seats, giving the government a relatively comfortable majority in the Parliament.

SYRIZA's drive against fiscal austerity resonated with many on the progressive side of European politics, although national governments maintained a cautious attitude. Political leaders found support among many public economist-intellectuals on both sides of the Atlantic, such as Paul Krugman, Simon Wren-Lewis, Amartya Sen, Tomas Piketty, Paul De Grauwe and Dani Rodrik (to mention but a few), who since 2010 had been critical of the EU's premature turn to austerity. Even the research department of the IMF had published criticism over the speed with which fiscal austerity had been implemented in Europe (cf. Blanchard and Leigh 2012). In essence, the view was reiterated that for the monetary union to function, more solidarity – in the sense of pooling more fiscal resources – was needed.

In spite of the fact that SYRIZA's ascent to government office had been predicted since 2012, its appointed ministers appeared to be rather unprepared to rise to the requirements of a political negotiation with Greece's creditors and their agents (the Troika). From the first few days following the elections, it became clear that no consistent line was being communicated by the government Greek officials, while there also appeared to be a lack of understanding of institutions and of who does what in the management of the Greek economic adjustment programme. Yanis Varoufakis – an economics professor who in his previous academic capacity had been very vocal as to what could get Europe out of the crisis, but who was an outsider to the party – was appointed minister of finance, and *de facto* chief negotiator.

Under his lead and given that he also thought that the bailouts were a major mistake for Greece, the new Greek government announced in early February 2015 that it intended to neither seek an extension of the bail-out nor accept the full final sub-tranche of the earmarked bail-out funds. The government also declared that the country would seek a debt swap (essentially a reduction in its net present value) rather than a write-down of its nominal value. Politically, this seemed a more palatable option for the leaders of the creditor Member States to pass through their parliaments, as the losses that they would bear in such a scenario are harder to track on the public finance accounts (Colasanti 2016). Varoufakis was confident that even if Greece defaulted on its loans (which it should not have taken out in the first place), the ECB would not allow the country to exit the Eurozone and would keep up the liquidity supply to its banks. That was in spite of two previous incidents with Ireland and Cyprus where it had become pretty clear that the ECB had controversially and covertly threatened to cut off liquidity to their respective banking systems, unless their governments sought and implemented economic adjustment programmes from the EU-IMF.

Varoufakis devised a proposal for 'a menu of debt swaps' in return for a commitment to a (smaller) primary government budget surplus over the years and an agenda for reform (Barbier 2015). A crucial assumption for his plan to work was that the ECB would either pay to the Greek government profits from bonds that the ECB had not exchanged in 2012[6], or that it would raise the limit on the T-bills (i.e. short-term bonds) that the Greek government could issue and Greek banks buy to an additional 10 billion euros, so as to allow the government to carry on honouring its financial obligations (that is, to not default) until a new agreement was reached.

As soon as they took office, the new Greek prime minister and minister of finance embarked on a tour of European capitals and a series of meetings with high-ranking EU and Eurozone officials, in the hope of gaining support for their aforementioned alternative proposal on the Greek debt (the debt swaps) and less austerity. This series of meetings, however, did not yield the hoped-for broad coalition against austerity. This was not surprising for the creditor Member States, who did not want to set a 'bad example' of concessions, in order to avoid moral hazard. Remarkably, however, the governments of periphery economies, especially Spain, equally expressed their opposition to a different treatment of Greece. Although these economies could potentially benefit from the precedent of a Greek debt write-down and an easing of austerity, most of them were on their way to completing their own painful economic adjustment programmes. Implemented under governments on the centre-right, these programmes had not spared Spain or Portugal from the dismal economic, social and political consequences that Greece suffered from. The risk was, however, that should the EU and the IMF make concessions to the Greek government, there would be a political backlash against the governments in the other bailed-out countries for not having negotiated hard enough. Moreover, statements by Varoufakis

6. For a total amount of 1.9 billion euros, a provision agreed in the context of the previous government's negotiation in the second bailout programme.

that Italy (with its very high debt/GDP ratio) was essentially insolvent threatened to spark a market reaction that could turn into a self-fulfilling prophecy.

On closer inspection, therefore, the cold shoulder that Athens received even from the Member States which had been ‘in the same boat’ was explained by the various national interests, to a large extent linked to the domestic politics in the other Member States. On the other hand, Eurozone members in Central and Eastern Europe with lower per capita income than Greece were also unhappy with the Greek government’s plea for debt forgiveness and less austerity.

2.3 Reality bites: the ECB’s move from a monetary to a political institution

On 4th February 2015, a few weeks before the expiry of the second bail-out programme, the European Central Bank announced that, as of 11th February, Greek government bonds would no longer be accepted as guarantees (collateral) for providing liquidity to the Greek banks via the normal ECB channels. Instead, Greek banks would have to rely on Emergency Liquidity Assistance, to be provided by the Bank of Greece in exchange for collateral, until some agreement was reached between the Greek government and its lenders. The Bank of Greece would have to comply with general guidelines issued periodically by the ECB, with regard to what collateral it could accept and how much liquidity it could extend. The ECB justified this decision by referring to its doubts as to whether the final evaluation of the second programme would be concluded on time so as to release funds to the Greek government and avoid a default. The ECB move was in fact in the opposite direction from that Varoufakis had assumed, as it made the provision of liquidity to Greek banks somewhat harder and more expensive.

In practice, the restriction in liquidity that followed was rather limited[7]. More important pressure points were two decisions which had been

7. Data from the Bank of Greece suggested about 8 billion euros out of the 56 that the Greek banking system owed to the Euro system in December 2014.

taken by the ECB well before the change in government in Greece (Whelan 2015b). First, the ECB had also placed a cap on the amount of Greek government T-bills (i.e. short-term bonds) which Greek banks could buy at 3 billion euros, a cap that it refused to raise. This cap imposed important budget constraints on the Greek government, as Greek banks were the main buyers for such bonds. Secondly, in 2013, the ECB had announced that, as of the 28th February 2015 – that is, the date of the end of the second bail-out – it would no longer accept as collateral bonds issued by the banks and guaranteed by the Greek government. By the end of December 2015, these bonds amounted to 25 billion euros of liquidity injected into the Greek banking system. Should the Greek government not have an agreement for financial support with its lenders after that date, it would be up to the ECB to decide whether or not to provide liquidity to the Greek banks. Although the ECB justified these constraints by its rules, commentators (Whelan 2015a and 2015b) suggested that this was rather its own interpretation of the rules and thus a political choice (rather than an obligation) to put pressure on the Greek government to stay in agreement with its lenders. This seems to confirm the argument that the ECB turned from a monetary to a political institution.

As the prospect of Greece's lenders adopting Varoufakis' proposals appeared less and less likely in February 2015, and as the date of the expiry of the second programme drew near, a bank-run, the first of that year, started taking place in slow motion. Depositors of Greek banks, worried about the uncharted territory into which a lack of agreement might lead, started withdrawing their savings from Greek banks[8]. The ECB did not make any explicit statement to reassure depositors about the safety of their money, as a central bank would do.

Under these pressures, and given the hard stance of its lenders, the Greek government sought a four-month extension of the second bail-

8. According to statistics from the Bank of Greece, in January (amid the political uncertainty relating to the general elections and the impending victory of SYRIZA) and February 2015 (during the standoff between the Greek government and the lenders), households and firms withdrew a total of 20.4 billion euros from Greek banks, bringing total deposits down to a 10-year low of 140.5 billion euros. The amount of withdrawals was even higher than the respective run on the banks in May-June 2012, when, following twin general elections, it appeared that Greece had come the closest it ever had to exiting the Eurozone.

out agreement on 19th February 2015, essentially endorsing the validity of the bail-out agreement. The lenders granted the request in exchange for a list of measures and reforms that the Greek government should develop further in order to receive the money. Essentially the agreement did not provide any liquidity to the Greek government, but kept the negotiations on the conditions under which the remaining funds would be released open, allowing the ECB to keep up appearances in maintaining the liquidity provision to the Greek banks via the Emergency Liquidity Assistance. The agreement also bought the government some time to spell out what it wanted to get out of the negotiations. The plan was that a full list of measures should be agreed upon as soon as possible, so as to allow at least a tranche of the earmarked money to be paid to the Greek government[9].

The relief that followed the February 2015 agreement on extension of the bailout programme did not, however, last for long. There appeared to be significant differences between the Greek government and its lenders in their understanding of the obligations. The lenders expected that the Greek administration would elaborate on the list of measures on the basis of which Greece was granted an extension. They also expected that it would collaborate with the technical teams of the Troika in order to operationalize and agree on which targets should be met and how, as a pre-requisite for any of the bail-out final tranche money being paid. The Greek government, on the other hand, was highly reluctant to cooperate with 'the Institutions' (as the Troika came to be known after January 2015). There were thus complaints that the government did not accept the technical discussions, the successful conclusion of which was a pre-requisite for the political decision to release funds. As the payments of Greek public debt started becoming due without any external funding and the Greek treasury felt the liquidity constraints, Tsipras started making appeals to Greece's EU fellow members to reach a 'political' decision to release some of the bailout money to ease the liquidity difficulties.

9. The government faced quite a steep schedule of rolling over 4.3 billion euros of T-bills (i.e. short-term bonds) and 2.3 billion euros to the IMF by the end of March 2015; and 2.4 billion of T-bills by April 2015.

Soon, it became increasingly clear that the Greek government was struggling for liquidity to meet its domestic and external obligations. In order to avoid an external or internal default on its obligations, the Greek government mopped up all available reserves of public entities in Greece to continue paying its obligations, including wages, pensions and IMF loans. This had consequences for the real economy: state arrears towards suppliers of goods and services grew while the expenditure of sub-national public entities was frozen. The results of diminishing liquidity did not take long to manifest themselves. In its early May 2015 Spring European Economic Forecast, the European Commission downgraded the predicted growth rate for 2015 for Greece from 2.5 to 0.5%, while the forecast of public debt as a share of GDP was raised compared to the winter forecasts from 170% of GDP to 180%. The predicted government budget balance turned from a surplus of 1.1% to a deficit of 2.1% of GDP. In terms of the programme, this deterioration meant that for the final programme evaluation to be concluded, the Troika would require even more fiscal austerity measures than a few months previously.

In the meantime, Varoufakis had alienated most if not all of his colleagues in the Eurogroup. They complained that they were tired of him delivering lectures at their meetings and instead wanted to see specific technical proposals to be discussed. He retorted that he tried to speak economics to them but no one seemed interested. Moreover, and contrary to the established norms of the Eurogroup, he made statements that suggested that the privacy and confidentiality of its meetings were not safe with him (Bickerton 2015a). Bowing to pressure from other Eurogroup members and the Troika, the Greek prime minister, in April 2015, replaced Varoufakis as the head of the Greek negotiation team with Euclid Tsakalotos, who seemed more willing to negotiate on a shared basis.

Disagreements continued into June 2015, and not just between the Greek negotiation team and the Troika but also between the IMF and the European Commission. Given that, in addition to the IMF, a sizeable loan repayment was also due to the ECB on 20th July, the sense of urgency for concluding an agreement that would release funds so as to avoid a default on payments to either of the two institutions increased again. Defaulting on IMF debt payments was a relatively rare occurrence. If Greece failed to pay back the ECB, all bets would be off.

Varoufakis' conjecture was that for self-preservation reasons, the ECB would eventually blink first and not cut off liquidity from the Greek banks as this would force Greece to exit and very likely trigger the disintegration of the Eurozone. In theory that was indeed a rational possibility. In practice, however, defaulting on its ECB payments was a huge gamble. If the ECB did not blink, the consequences for Greece would be momentous, both economically and politically.

Public weariness about the prospect of a Greek exit from the Eurozone increased, re-igniting the bank-run in slow motion. Cash in the coffers of Greek banks reached new lows in June 2015. Should Greece leave the Eurozone, all deposits in Greek banks would be redenominated from Euros to a new currency, which would most certainly suffer from a sharp depreciation at least in the short term, leading to a reduction in the asset value of households and firms. Greece relied heavily on imports of basic goods, which would become much more expensive, thus leading to further sharp deterioration of incomes.

Last but not least, Greece has never had a track record of fiscal and monetary policies compatible with price stability, which is why, prior to joining the EMU, governments and businesses faced relatively high interest rates for borrowing. Should it re-introduce its own currency, it would have to either return to high interest rates or pursue fiscal and monetary policies even more conservative than those of the Eurozone.

Faced with these risks, the prime minister realised that not reaching a compromise with the lenders would lead the country in a direction for which there was no plan, preparation or even clear public support from the majority of Greeks. His view, however, was not shared by several prominent members of his party and ministers of the government. Not reaching an agreement would be detrimental for both sides. However, it was becoming clear that, given its economic and financial situation, Greece would suffer even more. Capitulating to an agreement would mean an even bigger U-turn than the previous Greek governments had committed and would go against every SYRIZA promise, except perhaps for that of staying in the Euro. The party was very likely to split and become the third big Greek party to collapse under the pressures of the economic adjustment programmes.

2.4 The July 2015 referendum: a Greek tragedy, again

Rather than taking responsibility for a decision, in the early hours of Saturday 27th June 2015, just four days before the expiry of the programme extension, Tsipras, without any prior warning to their opposite-numbers in the negotiations, called a referendum for Sunday 5th July 2015. In this referendum, organised with just a week's notice, contrary to the Council of Europe's guidelines[10], the Greek people would have to decide whether they were willing to accept a version of the Troika proposal to conclude the pending evaluation and receive funds – which was still under negotiation – or not. The prime minister made it clear that he would campaign in favour of 'No', although the leader of his right-wing coalition partner, Kammenos, clarified that if a better offer came from the lenders in the course of the week, the government would tilt its support in favour of 'Yes'. The prime minister's calculation was that, given how close the Greek exit from the Euro appeared to be, the Greek people would grit their teeth and vote in favour of the programme. He could then either resign, admitting defeat but maintaining his record clean from adopting austerity policies, or reach an agreement, on the pretext that he bowed to the people's mandate.

Following the referendum announcement, the ECB essentially blocked the provision of further liquidity to the Greek banks by deciding to place a cap on the Emergency Liquidity Assistance (ELA), at the level of 26th June 2015. Since Greek citizens were expected to rush in panic to withdraw whatever deposits they had still in the banks, the cap on ELA meant that the banks would not be able to honour these requests. Consequently, a bank holiday was declared as of Monday 29th June 2015 and capital controls were imposed, which at the time of writing this chapter (October 2016), are still in place.

On 30th June 2015, one day before the Greek repayment of 1.6 billion euros to the IMF was due, the Tsipras government submitted a request to the Eurogroup for the provision of a bridging loan from the ESM. This loan was to cover the financing needs of Greece for the period 2015-2016, the restructuring of the Greek public debt and the extension

10. The Council of Europe issued a statement to that effect reported in media across the world.

of the second bail-out programme until the approval of the aforementioned request. In the absence of any response, by the end of the day Greece officially entered into arrears with the IMF with regard to its payment of the 1.6 billion Euros due, the first country ever to do so since Zimbabwe in 1983. Following this, the European Commission informed the Greek government on behalf of its European lenders that the EFSF had in principle the right to declare all loans provided to the Greek government immediately payable, as Greece had violated the condition of timely repayment to the IMF.

At the referendum, 62.5% of registered voters turned up and 62% of these voters voted ‘No’. The week that followed was dramatic. The night of the referendum, it appeared that Greece was on a direct collision course with the EU and the IMF. However, it soon became apparent that the Greek Prime Minister had made up his mind to strike a compromise with the lenders. The following day, finance minister Varoufakis resigned and was replaced by the more moderate and low-profile Euclid Tsakalotos. Having secured the support of the leaders of all Greek parliament parties, bar the Communists (KKE) and the neo-Nazis (Golden Dawn), Tsipras and Tsakalotos attended an extraordinary Euro-summit and Eurogroup on 7th July 2015, where they were presented with a tight timetable for resolving the crisis. It was clear that a new bail-out would be necessary.

The Greek government was asked to submit a detailed programme of measures and reforms by the morning of Friday 10 July 2015. The programme would then have to be evaluated by the Troika before it was discussed at yet another extraordinary Eurogroup meeting on Saturday 11th July 2015, followed by another Euro summit. An EU summit was then also planned for Sunday 12th July 2015. There were indications that EU leaders were preparing for the possibility of *not* reaching an agreement with Greece and having to discuss how to provide humanitarian support to the Greek people in the event of ‘Grexit’. For its part, the ECB kept the financing constraints tight, and would only provide as much liquidity as strictly necessary to maintain the situation of the previous weeks, i.e. with the banks closed and controls on capital movements and withdrawals from banks. In the evening of 9th July 2015, the Greek government submitted its proposal requesting a new bail-out, which was pretty much along the lines of the one that was rejected at the referendum.

On 11th July, rather than taking action that would de-escalate the crisis and help reach an agreement fast, the German ministry of finance circulated a non-paper that criticized the Greek proposal as an insufficient basis for a new bail-out. The paper stated that the measures were based on, and even fell short of, the latest proposal of the Troika with a view to the final review of the previous bail-out, which 'Greece was not able to conclude'. Moreover, the non-paper stated that the Greek proposal lacked a number of reforms that would be vital to modernize the country, foster long-term economic growth and sustainable development. The proposed labour market reform, reform of the public sector, privatisations, banking sector and structural reforms were not deemed sufficient. The German non-paper suggested that Greece should improve its proposals to rebuild confidence, ensure debt sustainability upfront and the successful implementation of the programme. Among the suggested improvements was the transfer of valuable Greek assets – 50 billion euros – to an external fund, to be privatized and used to pay back the debt, and automatic spending cuts in case budget targets were missed. Should the Greek government fail to provide such improvements, the non-paper suggested a 'temporary time-out' from the Eurozone of five years to allow for debt restructuring. In such a case, humanitarian and technical assistance should be provided to Greece by the EU while steps should be taken to strengthen the governance of the Eurozone.

At the Eurogroup meeting that preceded the Euro summit, 15 out of 18 ministers of finance agreed with the evaluation of the non-paper that the measures proposed by Greece were not sufficient for agreement on a third bail-out, the only exceptions being the ministers of France, Italy and Cyprus. At the Euro summit that followed, François Hollande, who in the previous months had emerged as an active mediator between Greece and Germany, took the lead in ruling out the idea that Greece should take a 'time-out' from Eurozone membership in order to reform without constraints on its economic policies. The Italian prime minister, together with the Irish and Cypriot Presidents, backed Greece. German Chancellor Angela Merkel was reportedly torn between different considerations. On the one hand, she felt that 'trust' between Greece and the other Member States had again been compromised and needed to be restored, presumably through hard measures. She was more hesitant, however, than her minister of finance as to the merits of a 'temporary' Greek exit, mostly due to geopolitical considerations.

Other small Member States, such as Belgium, Finland, Slovakia, Malta and Estonia, lined up with Germany whereas the other southerners aligned themselves with France, even though they had been in favour of not letting Greece off the hook too easily.

Following difficult negotiations that lasted 17 hours, the Euro summit of the following day reached agreement on granting further support to Greece on the condition that it immediately legislated on a series of measures. A month later, on 14 August 2015, the new agreement was voted through the Greek parliament. Greece would receive a total of 86 billion euros for the following 3 years, in exchange for a third programme of economic adjustment, which provided for measures much harder and more extensive than the ones which had led to elections earlier that year.

Thus, in less than six months, any Greek hopes for policy change but also for recovery had been shattered. The new Greek government was a coalition of two parties that had been waging opposition against the former mainstream Greek parties for signing up to the bail-out programmes and accepting the terms imposed by the lenders, and which had been promising to do away with austerity, the Troika and the loans. Yet now it found itself signing up to a third bail-out, following, as described above, the imposition of capital controls and having come closer than ever to exiting the Eurozone. What was worse, any signs of forthcoming recovery had evaporated, after the economy had suffered financial asphyxiation due to the lack of liquidity and the bank-run in slow motion that eventually culminated with the capital controls and the extended bank holiday.

3. Is there a future for solidarity in the Eurozone?

3.1 Differing views as to the meaning of inter-state solidarity

The way the 2015 Greek crisis was handled shows that some common sense of purpose and sense of solidarity, even if selfishly-motivated, still exists in the EU. After all, several (non-negligible) Member States did successfully stand up to the German ministry of finance's suggestion of 'time out'. However, the way in which some of the creditors treated the legitimate Greek request for a relaxation of policies judged detrimental by mainstream economists suggests not simply an absence of solidarity. It suggested a willingness to continue punishing a country, in spite of many reforms, a significant drop in living standards (cf. De Grauwe 2015) and even the collapse of the party-political system.

It is impossible to assess whether a negotiating team with more diplomatic skills, better understanding of the institutional construction of the Eurozone and pragmatism would have achieved a more solidaristic outcome. Playing by the established rules and procedures of negotiation is necessary to build trust (i.e. to show that one is a responsible counterparty), especially when a radical change in the course of action is sought. The fact that the lenders decided to not make any concessions to the previous Greek government (which was led by a party of the EPP family) in view of SYRIZA's expected electoral victory, suggests that the lenders might have stuck to their approach anyway. These questions notwithstanding, to portray Germany's harsh proposals of the weekend of 11th-12th July 2015 as necessary to 'restore trust' is remarkable. Indeed, the creditors' side postponed indefinitely the discussion of any further relief, not keeping to the promise made by the European Council of November 2012 to open this discussion once Greece achieved a government budget surplus. This was clearly a stance that reflected the existence and exploitation of a large asymmetry in power between Member States that are supposed to be equal in an 'ever closer union'.

The differences between Member States' perceptions of what shape and size inter-state solidarity should take are thus alive and kicking. At the same time, the views that dominate policy responses are likely to be closer to those of the most powerful creditors, in particular Germany. The way the crisis was resolved demonstrated, however, that divisions exist even within the group of creditor Member States, most notably between a group led by Germany and consisting of small Member States like Finland, the Baltics and Slovakia, on the one hand, and another group led by France and Italy on the other. The current common sense of purpose is nowhere near sufficient to take a leap forward towards more supranational integration in a way that would put an end to the economic crises.

It is often argued that, under the pressure of the sovereign debt crisis, the EU and the Eurozone in particular have come a long way in addressing shortcomings in the institutional architecture, in a way which would have been unthinkable several years ago (Colasanti 2016). The most prominent examples of progress are the mechanism for financial crisis resolution, the European Stability Mechanism, and the first steps towards the establishment of a banking union, but also the launch of Outright Monetary Transactions (OMTs) by the ECB. However, these steps have been organized in a way that reflects the kind of inter-state solidarity demonstrated in the Greek case: the amount of pooled resources has been lower than necessary to be effective, whereas the conditions for accessing these resources seem to be more dictated by the wish to avoid moral hazard and the establishment of a transfer union than by a desire to ensure stabilization in the face of a crisis.

3.2 A more solidaristic governance in the Eurozone: what can be done?

The dominant perceptions of the definition, degree and conditions of provision of inter-state solidarity are far from optimal. For a way to be found towards a more solidaristic governance in the Eurozone, it is important to highlight two problems. On the one hand, Member States are not willing to pool significant financial resources or political sovereignty at the supranational level. On the other hand, Member States and the ECB are concerned about moral hazard: for example, financial support with too few strings attached or less strict fiscal rules leading to less fiscal discipline. Both of these issues have resulted in suboptimal crisis responses and stability in the Eurozone. The lack of appetite for further integration can only be tackled by making clear what minimum level of economic policy integration is indispensable for a functioning monetary union. On the issue of moral hazard, however, there is probably more scope for improvement by changing the content of the fiscal policy rules or the philosophy of economic adjustment programmes attached to bail-outs. The two issues are closely connected.

National fiscal policies have been under extreme pressure to do more than they should for three main reasons: (a) the excessive focus of fiscal rules on meeting budget deficit targets, as opposed to contributing to the stabilization of the economy; (b) the current adverse macroeconomic circumstances, resulting in the limited potential of ECB monetary policy to stabilize the Eurozone economy; and (c) the fact that national fiscal policies are still, to an extent, responsible for stabilizing national banking systems in case of problems (Mabbett and Schelkle 2015). Thus, making progress with the completion of the banking union would be a way of ensuring that fiscal policies effectively meet fiscal rules.

Furthermore, fiscal rules should be changed to allow for more flexibility at the national level and the adoption of an appropriate aggregate fiscal stance by the Eurozone as a whole. Rather than targeting arbitrary, if not outright harmful, deficit and debt/GDP ratios, rules should be set so that national fiscal policies aim at a real exchange rate that is compatible with full employment in an economy over the medium term. In the national fiscal policy context, this could be done by stimulating (contracting) demand to result in higher (lower) national inflation relative to the ECB target, which would lead to real exchange rate appreciation (depreciation).

The fiscal stance for each Member State would be determined according to the necessary aggregate fiscal stance and the appropriate alignment of real exchange rates: those with lower inflation rates over a period, which were not justified by relative productivity differentials vis-à-vis other Member States, would be required to expand their fiscal policies more than those with relatively relatively high inflation rates (cf. Allsopp and Watt 2003; Theodoropoulou 2015). This need would also give rise to different national inflation rate targets, which taken together should, however, aim at averaging at least the 2% inflation target of the ECB. The recently appointed European Fiscal Board in collaboration with the national Fiscal Boards would be in a position to provide analysis that would make it possible to suggest appropriate national inflation rate targets and fiscal policy stances, emphasising the need for Member States whose economies are going through booms and recessions to make equal and opposite efforts to meet these targets. Insofar as such fiscal rules would actively promote stabilization at the national and Eurozone level, they would make compliance easier and more credible, offering reassurances against moral hazard.

While cases of financial support programmes are different, a more Keynesian philosophy on how to support countries during adjustment could help to allocate the sums of the financial envelope somewhat differently across the functions they usually serve: bank recapitalization, debt rollover and budget financing. Allowing more budget financing could thus plausibly result in lower bank recapitalization and debt rollover needs. Other things being equal, the milder the austerity pressed upon distressed Member States and their populations, the lighter the adverse effects to the real economy, paving the way for a faster return to the markets and a more limited deterioration of bank balance sheets. Such a shift would be more about winning the battle of ideas or transmitting the insights of economic theory to the relevant policy headquarters (for a discussion of this, see Wren-Lewis 2015 and 2016) than going against the public opinion of Member States.

Collective wage bargaining institutions with high coordination capacity can work with fiscal policies in their targeting of intra-Eurozone real exchange rates, and help avoid greater imbalances. To do so, however, collective bargaining institutions should be strengthened rather than weakened through the deregulation of bargaining. Collective bargaining should aim to deliver nominal wages in accordance with the so-called Golden Rule, which states that nominal wages should, on average, increase by the medium-term average national productivity growth rate plus the target inflation for the Member State, adjusted for a price competitiveness component, which will be positive (negative) for economies with current account surpluses (deficits).

These changes in the philosophy governing the coordination of national economic policies, vital for stability in the Eurozone, would also have salutary effects on the ECB. In the current circumstances of zero nominal interest rates, the more fiscal policies pull their weight by stimulating demand in the Eurozone, the less the ECB will have to use unconventional tools (i.e. buy government bonds) to that end. Moreover, the more credible the fiscal rules are, the less concerned the ECB would be about moral hazard and the less constrained its actions would be as a lender of last resort.

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