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A Hybrid Conservatorship Model for Greece?

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Brussels is host to a confused gaggle of European Union leaders as they summit for yet another crack at the Greek puzzle today. Greek Prime Minister George Papandreou's 1 week ultimatum has not yielded any neat solutions for EU leaders. Here's a look at the various options and their feasibility.

Option 1: EU bailout for Greece: As Angela Merkel has repeatedly acknowledged, Greece cannot be bailed out under existing EU law. The Treaty of the European Union does not allow states to be bailed out without significant interpretive acrobatics. Article 125 is very clear that the "Union shall not be liable for or assume the commitments of central governments... or public undertakings of any Member State..." Further, "a Member State shall not be liable for or assume the commitments of central governments... of another Member State..." In addition, article 123 prohibits "overdraft facilities or any other type of credit facility with the ECB or with the central banks of Member States in favour of central governments."

So, how does the EU get around these legal hurdles? It could use the escape valve contained in article 122 but that would require a sleight of hand: overlooking the fact that Greece's problems are not caused by "natural disasters or exceptional circumstances beyond its control" as required by article 122.

Papandreou knows that EU law stands in the way of a bailout, but he is relying on two things: first, the EU is notorious for a lackadaisical approach to its own rules; and second, German and French banks are most exposed to Greek debt, meaning that Germany and France have self-interested reasons to support a bailout. As Keynes said so memorably, "if I owe you a pound, I have a problem; but if I owe you a million, the problem is yours."

As is increasingly likely, the IMF might be essential to a bailout, accepting the reality that Europe cannot solve its problems alone.

Regardless of how a bailout is structured, it would be an ad hoc response to a deep-rooted systemic problem in the monetary union project. It will set a dangerous precedent, encourage moral hazard, fuel popular unrest in societies that did not receive bailouts, and can become unmanageable if larger states like Spain make similar demands.

Option 2: Kick Greece Out: Intense hostility to bailing out a country that pulled the wool over European eyes by cooking its books has moved even a traditionally cautious Merkel to suggest expulsion. She demanded "an agreement under which, as a last resort, it's possible to exclude a country from the euro zone if again and again it doesn't fulfill the requirements."

Although such punitive sentiments are understandable, EU law does not currently suggest an easy expulsion mechanism. Confusion is rife over whether it's permissible to expel a member state from the European Monetary Union without also expelling it from the EU.

This is not to say that a member state cannot withdraw from the EU or EMU. Such a withdrawal might be unilateral or negotiated with other member states. But coercion is not an option.

A negotiated withdrawal would be painful medicine but might be the best long-term solution. It would allow Greece to float its own currency, devalue it, and fix internal problems. The danger is that no one knows the precise ambit of the risk entailed by such drastic ation. Aside from Greek instability, there are also risks posed by larger countries like Spain and Italy following suit. Portugal's credit rating downgrade this week must also be considered. If other states follow the withdrawal route, the European Monetary Union would all but shrink to a Franco-German union.

These risks make Greece's exit from the eurozone highly unlikely.

Option 3: Put Greece into conservatorship: Although not an exact analogy, Fannie Mae and Freddie Mac -- the twin towers of mortgage finance in the United States -- were placed into conservatorship to ensure their survival. Why not follow that model?

Conservatorship is designed to stabilize the enterprise and keep it afloat. Debts are backed up and management is replaced. The systemic risks presented by the collapse of Fannie and Freddie necessitated government intervention going beyond the injection of money. These GSEs had been hobbled by poor leadership and even poorer oversight for years. Seizing control was the only option. Treasury Secretary Paulson's move was a bold one because Fannie and Freddie had maintained all along that they were adequately capitalized and satisfied regulatory requirements. They also had powerful backers on Capitol Hill.

Greece is not too dissimilar. Merely loaning money -- bilateral or multilateral -- may not be enough given what we know about the quality of governance and financial reporting in that country. Having been led up the garden path about single digit deficits only to be shocked with the 12.7% of GDP deficit figure, the EU must exercise extreme caution before crafting any rescue plan.

There is yet another reason to be cagey: regime risk. Greece has witnessed massive strikes over proposals to pare down the deficit by 4%.

Domestic turmoil signals political regime risk -- essentially the threat to the credibility of a government's promises caused by the divergence between the regime's plans for required reforms and their acceptability to the population.

Papandreou might make promises in good faith to secure a rescue plan but if his people are not behind him the durability of these undertakings are open to serious doubt. What if a new government repudiates these promises and engages in profligate ways? Taxpayers in states contributing to the bailout might as well kiss their money goodbye.

This risk cannot be dismissed out of hand. It cannot be minimized by bilateral covenants either. This is why reform of EU law is essential to cover violations of the Growth and Stability Pact. A spectrum of options ranging from minimally intrusive bailouts to conservatorship to outright expulsion from the eurozone must be available.

To be sure, conservatorship diminishes sovereignty. Setting aside high-faluting homilies about sovereignty, realistically how sovereign is a state deeply in debt? And, the unpleasantness of conservatorship limits the moral hazard of bail-out.

If regarded as a form of fiscal guardianship, a hybrid form of conservatorship ought to be feasible. There is no need to transfer all governance power in exchange for a bailout. An outside guardian to oversee financial decisions is sufficient. Critics will respond that no government function can be carried out without financial consequences. Although this is true, what is wrong with limiting government policy to affordable programmes?

Injecting parsimony into government will also curb the tendency in Europe to build a nanny state and leave greater room for private initiative.

None of the above options is unproblematic. They involve stretching EU law to breaking point or creating new rules to address systemic flaws. Choosing the right option is vital for the long-term viability of the Euro.