

The EMU as a Self-Destroying System

by Philipp Bagus on June 21, 2011

[Excerpted from [Tragedy of the Euro](#) (2010)]

When property rights in money are poorly defined, negative external effects develop. The institutional setup of the euro, with its poorly defined property rights, has brought it close to collapse and can be called a tragedy of the commons.^[1]

Fiat Money and External Costs

External costs and benefits are the result of ill-defined or ill-defended property rights.^[2] The proprietor does not assume the full advantages or disadvantages of employing a property. As the actor is not fully responsible for the effects of his actions, he will not take into account all the consequences of his actions.

The actor that does not reap some of the benefits of his actions will not take into account all the positive effects of it. An example of these positive (external) benefits might be an apple-tree owner whose property rights over the apples growing on the tree are not secured. People walking down the street just grab any apples within their reach. This behaviour is permitted by the government. The apple-tree owner would probably act differently were he the sole benefactor of the tree. He might not protect the tree against insects, or he might even cut the tree down to burn the wood.

Similarly, the proprietor may incur some external costs. External costs result from the absence of property rights. External costs do not burden the proprietor, but others. The proprietor will engage in some projects he would not have if he had had to assume all costs. An example of external costs would be the owner of a factory that dumps its waste into a public lake. This lake may be privately owned by a third party, but the government does not defend the property rights of the lake's owner because it regards the factory as essential for economic growth. In this scenario the factory owner does not have to assume the full cost of production but can externalize some part of the costs to others by dumping the waste. If the factory owner had to pay for its disposal, however, he would probably act differently. He might produce less, or operate in a more waste-preventing way. Since the property rights of the lake are not well defended or not defined at all (in the case of public property in the lake), the factory owner is released from the responsibility of some of the costs incurred. As a consequence, there is more pollution than would be seen otherwise.

In our present monetary system there are several levels on which property rights are not clearly defined and defended. At a first level, private-property rights are absent in the field of base-money production. The private money, gold, was nationalized during the 20th century. And private money production of commodity moneys belongs to the past.

It is important to point out that under the gold standard there were no external (technological) effects involved in base-money production. Private gold producers incurred substantial costs mining the gold and they reaped the full benefits. It is true that the increase in the gold money supply tended to push up prices and, therefore, involved pecuniary external effects. But an increase in the production of goods affecting the purchasing power of money and relative prices does not imply any private-property violation. Anyone was free to search for and mine gold and could sell it on the market. No one was forced to accept the gold in payment. Moreover, private property in base-money production was defended.

The loss in purchasing power caused by mining brought along redistributive effects. Redistributive effects alone, however, do not imply external effects. Any change in market data has redistributive effects. If the production of apples increases, their price falls, benefiting some people, especially those who like apples. If there is a free-market increase of gold money or apples, there is redistribution, but no bad application of private-property rights and, consequently, no external (technological) costs.

Furthermore, the increase in gold money did not have the negative external effect of decreasing the quality of money.^[3] By increasing the number of gold coins, the average metal content of a gold coin was not reduced. Gold could continue to fulfil its purposes as a medium of exchange and a store of value.

During the 20th century, governments absorbed and monopolized the production of money. Private gold money with clearly defined property rights was replaced by public fiat money. This money monopoly itself implies a violation of property rights. Central banks alone could produce base money, i.e., notes or reserves at the central bank. Property rights are also infringed upon because fiat money is legal tender. Everyone has to accept it for debt payments and the government accepts only the legal-tender fiat money for tax payments.^[4]

By giving fiat money a privileged position and by monopolizing its production, property rights in money are not defended and the costs of money production are partially forced upon other actors. If no one had to accept public paper money and everyone could produce it, no external costs would evolve. People could simply decide not to accept fiat money or produce it themselves.

The benefits of the production of money fall to its producer, i.e., central banks and their controllers (governments). External costs in the form of rising prices and, in most cases, a lower quality of money are imposed on all users of fiat money. Not only do additional monetary units tend to bid up prices, but the quality of money tends to fall as well. The average quality of assets backing the currency is normally reduced by fiat-money production.

Imagine that 20 percent of the monetary base is backed by gold reserves. If the central bank buys government bonds or mortgage-backed securities, or increases bank lending and increases the supply of fiat base money by 100 percent, the average quality of base money falls. After these expansionary policies, only 10 percent of base money is backed by gold and 90 percent is backed by assets of a lower quality.

The gold-reserve ratio is even relevant if there is no redemption promise. Gold reserves can prop up confidence in a currency and can be used in panic situations to defend the currency. They are also important to have in the case of monetary reforms. In contrast to the fiat-paper situation, where an increase in money supply dilutes the quality of the currency, there is no dilution in the quality of the currency by gold mining. By minting new coins, the quality of previously existing gold coins is untouched.

Due to the infringement on private-property rights in base-money production, governments can profit from base-money production and externalize some costs. The benefits for governments are clear. They may finance their expenditure with the new money through the detour of the central bank. Costs are shifted onto the population in the form of a lower quality of money and a lower purchasing power of money.

The Tragedy of the Commons and Banking

Another layer in the monetary system of ill-defined property rights is the tragedy of the commons in banking. A "tragedy of the commons," a term coined by Garrett Hardin,^[5] is a special case of the external-costs problem. As explained above, external costs generally occur when property rights are not well-defined or defended, and when a single privileged owner can externalize costs on others. This is the case of the factory owner being allowed to dump waste in the private lake or the case of the central bank producing legal tender base money supported by the state. In a tragedy of the commons, a specific characteristic is added to the external-cost problem. Not one but several actors exploiting one property can externalize costs on others. Not only one factory owner but many can dump waste into the private lake. Likewise, more than one bank can produce fiduciary media.

The traditional examples for a tragedy of the commons are common properties such as public beaches or swarms of fish in the ocean. They are exploited without regard to the disadvantages that can be partially externalized. Benefits are obtained by numerous users, but some of the costs are

externalized. Let us look at the incentives for a single fisherman. By fishing the swarm, the fisherman obtains the benefits in the form of the fish; however, the cost of a reduced size of the swarm is borne by all.

If there were private-property rights that defined the swarm, the swarm's owner would fully assume the costs of reducing its size. The owner would have an interest in its long-term preservation. He would not only own the present use (hunted fish) but also the capital value of the swarm. The owner knows that every fish he catches may reduce the number of fish for the future. He balances the costs and benefits of fishing and decides consequently on the number of fish he wants to catch. He has an interest in the capital value or long-term preservation of the swarm.

The situation changes radically when the swarm is public property. There is an incentive to overfish (i.e., overexploit) the resource because the benefits are internalized and the costs are partially externalized. All benefits go to the fisherman, whereas the damage suffered through the reduction of the swarm is shared by the whole group. In fact, there is the incentive to fish as fast as possible, given the knowledge of the incentives for other fishermen. If I do not fish, another will fish and get the benefits, whereas I bear the costs of the reduced size of the swarm. In a "pure" tragedy of the commons, there are no limits to overexploitation, and the resource disappears as a result.

The concept of the tragedy of the commons can be applied successfully to other areas such as the political system. Hans-Hermann Hoppe^[6] applied the concept to democracy. In a democracy there is public entrance into government. In government one gains access to the property of the whole country by using the coercive apparatus of the state. Benefits of appropriation of private property are internalized by the government while costs are borne by the whole population. After one term, other people may gain access to the coercive apparatus. Thus, the incentive is to exploit the privilege to its limits as much as possible while in power.

Another fruitful application of the tragedy of the commons is in the monetary field. In our modern banking system,^[7] where property rights are not clearly defined and defended,^[8] any bank can produce fiduciary media, i.e., unbacked demand deposits, by expanding credits. At the level of base money, when a single central bank can produce money, there is no tragedy of the commons. Yet, at the level of the banking system, a tragedy of the commons occurs precisely because any bank can produce fiduciary media.

In banking, traditional legal principles of deposit contracts are not respected.^[9] It is not clear if bank customers actually lend money to banks or if they make genuine deposits. Genuine deposits require the full availability of the money to the depositor. In fact, full availability may be the reason why most people hold demand deposits. Yet banks have been granted the legal privilege to use the money deposited to them. As such, property rights in the deposited money are unclear.

Banks that make use of their legal privilege and the unclear definition of private-property rights in deposits can make very large profits. They can create deposits out of nothing and grant loans to earn interest. The temptation to expand credit is almost irresistible. Moreover, banks will try to expand credit and issue fiduciary media as much and as fast as they can. This credit expansion entails the typical feature found in the tragedy of the commons — external costs. In this case, everyone in society is harmed by the price changes induced by the issue of fiduciary media.

There are, however, several differences between a fractional-reserve banking system and a tragedy of the commons (like a public fish swarm). In Hardin's analysis, there is virtually no limit to the exploitation of the "unowned" properties that have no clearly defined ownership. Further exploitation of the public resource stops only when the costs become higher than the benefits, i.e., when the swarm is so small that searching for the remaining fish is no longer worthwhile. Likewise, for the fractional-reserve banks on the free market, there are important limits on the issuing of fiduciary media at the expense of clients. This limit is set by the behaviour of the other banks and their clients in a free banking system. More specifically, credit expansion is limited since banks, via the clearing system, can force each other into bankruptcy.

Let's assume there are two banks: bank A and bank B. Bank A expands credit while bank B does not. Money titles issued by bank A are exchanged between clients of bank A and clients of bank B. At some point, the clients of bank B, or bank B itself, will demand redemption for the money titles from bank A. Hence, bank A will lose some of its reserves — for instance, gold. As is every fractional-reserve bank, bank A is inherently bankrupt; it cannot redeem all the money titles it has issued. If bank B and its clients demand that bank A redeem the money titles to a degree that it cannot fulfil, bank A must declare bankruptcy.

The clearing system and the clients of other banks demanding redemption set narrow limits on the issuing of fiduciary media. Banks have a certain incentive to restrict expansion of fiduciary media to a greater extent than their rival banks, with the final aim being to force their competitors into bankruptcy. In other words, these banks naturally want to exploit the great profit opportunities offered by the improperly defined property rights, but they can only expand credit to the extent that the risk of bankruptcy is reasonably avoided. Competition forces them to check their credit expansion.

The question now concerns how the banks can increase the profits from credit expansion while keeping the risk of bankruptcy low. The solution, obviously, is to form agreements with each other in order to avoid the negative consequences of an independent and uncoordinated credit expansion. As a result, banks set a common policy of simultaneous credit expansion. These policies permit them to remain solvent, to maintain their reserves in relation to one another, and to make huge profits.

Therefore, the tragedy of the commons not only predicts the exploitation and external costs of vaguely defined private property; it also explains why there is pressure in a free banking system to form agreements, mergers, and cartels. However, even with the forming of cartels, the threat of bankruptcy remains. In other words, the incentive to force competitors into bankruptcy still remains, resulting in the instability of the cartels.

For fractional-reserve banks, there is a great demand for the introduction of a central bank that coordinates the credit expansion of the banking system. The one difference between the tragedy of the commons applied to the environment and the tragedy of the commons applied to a free banking system — limits on exploitation — is now removed by the introduction of the central bank. Hence, according to Huerta de Soto, a true "tragedy of the commons" situation occurs only when a central bank is installed. The banks can now exploit the improperly defined property without restriction.

Even in the most comfortable scenario for the banks, i.e., the installation of a central bank and fiat money, there remain other limits. The central bank may try to regulate bank lending and thereby control and limit credit expansion to some extent. The ultimate check on credit expansion — the risk of hyperinflation — remains as well. In other words, even with the creation of a central bank, there is still a check on the exploitation of private property. In an ideal "tragedy of the commons" situation, the drive is to exploit ill-defined property as quickly as possible and forestall exploitation of other agents. But even with the existence of a central bank that guarantees their solvency, it is not in the interest of the fractional-reserve banks to issue fiduciary media as quickly as possible. To do so could lead to a runaway hyperinflation. The exploitation of the commons must therefore be stretched and implemented carefully.

The overexploitation of public property can be restricted in several ways. The simplest way is a privatization of the public property. private-property rights are finally defined and defended. Another solution is the moral persuasion and education of the actors that exploit the commons. For instance, fishermen can voluntarily restrict the exploitation of the swarm. A further option is the regulation of the commons to restrict the overexploitation of the tragedy of the commons. Hardin^[10] calls these regulated commons "managed commons." Government limits the exploitation.

An example is the introduction of fishing quotas that provide every fisherman a certain quota per year. Each receives a monopoly right that he will try to exploit fully. Overexploitation is, thus, reduced and managed. In the case of today's banking system, we have a managed commons. Central banks and banking regulation coordinate and limit the credit expansion of banks. By requiring minimum reserves and managing the amount of bank reserves as well as the interest rates, central banks can limit credit expansion and the external costs of the reduced purchasing power of money.

The Euro and the Tragedy of the Commons

Although the external effects of a monopolistic money producer and a fractional-reserve banking system regulated by a central bank are common in the Western world, the establishment of the euro implies a third and unique layer of external effects. The institutional setup of the Euro system in the EMU is such that all governments can use the [ECB](#) to finance their deficits.[\[11\]](#)

A central bank can finance the deficits of a single government by buying government bonds or accepting them as collateral for new loans to the banking system resulting. Now we are faced with a situation in which several governments are able to finance themselves via a single central bank: the ECB.

When governments in the EMU run deficits, they issue bonds. A substantial part of these bonds are bought by the banking system.[\[12\]](#) The banking system is happy to buy these bonds because they are accepted as collateral in the lending operations of the ECB.[\[13\]](#) This means that it is essential and profitable for banks to own government bonds. By presenting the bonds as collateral, banks can receive new money from the ECB.

The mechanism works as follows: Banks create new money by credit expansion. They exchange the money against government bonds and use them to refinance with the ECB. The end result is that the governments finance their deficits with new money created by banks, and the banks receive new base money by pledging the bonds as collateral.

The incentive is clear: redistribution. First users of the new money benefit. Governments and banks have more money available; they profit because they can still buy at prices that have not yet been bid up by the new money. When governments start spending the money, prices are bid up. Monetary incomes increase. The higher the deficits become and the more governments issue bonds, the more prices and incomes rise. When prices and incomes increase in the deficit country, the new money starts to flow abroad where the effect on prices is not yet felt. Goods and services are bought and imported from other EMU countries where prices have not yet risen. The new money spreads through the whole monetary union.

In the EMU, the deficit countries that use the new money first win. Naturally, there is also a losing side in this monetary redistribution. Deficit countries benefit at the cost of the later receivers of the new money. The later receivers are mainly in foreign member states that do not run such high deficits. The later receivers lose as their incomes start to rise only after prices increase. They see their real income reduced. In the EMU, the benefits of the increase in the money supply go to the first users, whereas the damage to the purchasing power of the monetary unit is shared by all users of the currency. Not only does the purchasing power of money in the EU fall due to excessive deficits, but interest rates tend to increase due to the excessive demand coming from over indebted governments. Countries that are more fiscally responsible have to pay higher interest rates on their debts due to the extravagance of others. The consequence is a tragedy of the commons. Any government running deficits can profit at the cost of other governments with more balanced budgetary policies.[\[14\]](#)

Imagine, for example, that several individuals possess a printing press for the same fiat currency. These individuals have the incentive to print money and spend it, bidding up prices. The benefits in the form of a higher income accrue to the owners of the printing press, whereas the costs of the action in the form of a lower purchasing power of money are borne by all users of the currency. The consequent incentive is to print money as fast as possible. A printing-press owner who does not engage in printing will see prices rise. Other owners will use the press in order to benefit from the loss in purchasing power that affects other printing-press owners. The owner who prints the fastest makes gains at the expense of the slower printing owners. We are faced with a "pure" tragedy of the commons. There is no limit to the exploitation of the resource.[\[15\]](#) As in the case of public natural resources, there is an overexploitation that ends with the destruction of the resource. In this case, the currency ends in a hyperinflation and a crack-up boom.

Although the example of several printing presses for the same currency helps us understand the situation in a visual way, it does not apply exactly to the EMU. But differences between the two setups

help explain why there is no pure tragedy of the commons in the Euro system and why the euro has not yet disappeared. The most obvious difference is that deficit countries cannot print Euros directly. Governments can only issue their own bonds. There is no guarantee that banks will buy these bonds and use them as collateral for new loans from the ECB.

In reality, there are several reasons why the scheme might not work.

1. Banks may not buy government bonds and use them as collateral if the operation is not attractive. The interest rate offered for the government bonds might not be high enough in comparison with the interest rates they pay for loans from the ECB. Governments must then offer higher yields to attract banks as buyers.
2. The default risk on the government bonds might deter banks. In the EMU this default risk has been reduced by implicit bailout guarantees from the beginning. It was understood that once a country introduced the euro, it would never leave the EMU. The euro is quite correctly seen as a political project and a step toward political integration.

The default of a member state and its resulting exit would not only be seen as a failure of the euro, but also as a failure of the socialist version of the European Union. Politically, a default is seen as next to impossible. Most believe that, in the worst case, stronger member states would support the weaker ones. Before it came to a default, countries such as Germany would guarantee the bonds of Mediterranean nations. The guarantees reduced the default risk of government loans from member states considerably.

Implicit guarantees have now become explicit. Greece was granted a rescue package of 110 billion Euros from the Euro zone and the International Monetary Fund (IMF).[\[16\]](#) In addition, 750 billion Euros have been pledged for further bailouts of other member states.[\[17\]](#)

3. The ECB could decline to accept certain government bonds as collateral. The ECB requires a minimum rating for bonds to be accepted as collateral. Before the financial crisis of 2008, the minimum rating was A-. During the financial crisis, it was reduced to BBB-. If ratings of bonds fall below the minimum rating, government bonds will not be accepted as collateral. This risk, however, is quite low. The ECB will probably not let a country fall in the future, and it has been accommodating with respect to the collateral rule in the past. The reduction of the minimum rating to BBB- was planned to expire after one year. When it became apparent that Greece would not maintain at least an A- rating, the rule was extended for another year. Finally, the ECB, in contrast to its stated principles of not applying special rules to a single country, announced it would accept Greek debt even if rated junk.[\[18\]](#)

4. The liquidity risk involved for banks using the ECB to refinance themselves by pledging government bonds as collateral may deter them. Government bonds are traditionally of a longer term than the loans granted by the ECB. There have traditionally been one-week and three-month loans in ECB lending operations. During the crisis, the maximum term was increased to one year. Nevertheless, most government bonds still have a longer term than ECB lending operations with maturities of up to 30 years. Consequently, the risk is that the rating of the bonds would be reduced over their lifetimes, and that the ECB might cease to accept them as collateral. In this scenario, the ECB would stop rolling over a loan collateralized by government bonds, causing liquidity problems for banks.

The risk of rollover problems is relatively low; the ratings are supported by the implicit bailout guarantee and the political willingness to save the euro project, as has been demonstrated by the sovereign debt crisis. Another side of the liquidity risk is that interest rates charged by the ECB might increase over time. Finally, they could be higher than the fixed rate of a longer term government bond. This risk is reduced by a sufficient interest spread between the yield of the government bond and the interest rates applied by the ECB.

5. Haircuts applied by the ECB on the collateral do not allow for full refinancing. A bank offering a million Euros worth of government bonds as collateral does not receive a loan of a million Euros from the ECB, but a smaller amount. The reduction depends on the haircut applied to the collateral. The

ECB distinguishes five different categories of collateral demanding applying different haircuts. Haircuts for government bonds are the smallest.^[19] The ECB, thereby, subsidizes their use as collateral vis-à-vis other debt instruments supporting government borrowing.

6. The ECB might not accommodate all demands for new loans. Banks might offer more bonds as collateral than the ECB wants to supply in loans. Applying a restrictive monetary policy, not every bank offering government bonds as collateral will receive a loan. However, for political reasons, especially the will to continue the euro project, one may expect that the ECB will accommodate such demands, especially if some governments are in trouble. Indeed, the ECB started offering unlimited liquidity to markets during the financial crisis. Any demand for a loan was satisfied — provided sufficient collateral was offered.

Even though we have not seen a pure tragedy of the commons in the Euro system, we have come close. With the current crisis, we are actually getting closer due to the ECB's direct buying of government bonds: The ECB announced the direct purchase of the bonds in May of 2010^[20] to save the euro project. If a government has deficits, it may issue bonds that are bought by banks and then by the ECB. Using this method, there is no longer a detour via the lending operations of the ECB. The ECB buys the bonds outright. The new development eliminates the majority of the aforementioned risks for the banking system.

The tragedy of the euro is the incentive to incur higher deficits, issue government bonds, and make the whole euro group burden the costs of irresponsible policies — in the form of the lower purchasing power of the euro.^[21] With such incentives, politicians tend to run high deficits. Why pay for higher expenditures by raising unpopular taxes? Why not just issue bonds that will be purchased by the creation of new money, even if it ultimately increases prices in the whole of the EMU? Why not externalize the costs of government spending?

The tragedy of the euro is aggravated by the typical short-sightedness of rulers in democracies:^[22] politicians tend to focus on the next election rather than the long-term effects of their policies. They use public spending and extend favours to voting factions in order to win the next election. Increasing deficits delays problems into the future and also in the EU abroad. EMU leaders know how to externalize the costs of government spending in two dimensions: geographically and temporarily. Geographically, some of the costs are borne in the form of higher prices by the whole Euro zone. Temporarily, the problems resulting from higher deficits are possibly borne by other politicians and only in the remote future. The sovereign-debt problems caused by the deficits may require spending cuts imposed by the EMU.

The incentives to run high deficits in the EMU are almost irresistible. As in our printing-press example, only if a country runs higher deficits than the others can it benefit. You have to spin the printing press faster than your peers in order to profit from the resulting redistribution. Monetary incomes must rise faster than the purchasing power of the currency falls. These tragic incentives stem from the unique institutional setup in the EMU: one central bank. These incentives were not unknown when the EMU was planned. The Treaty of Maastricht (Treatise of the Economic Community), in fact, adopted a no-bailout principle (Article 104b) that states that there will be no bailout in case of fiscal crisis of member states. Along with the no-bailout clause came the independence of the ECB. This was to ensure that the central bank would not be used for a bailout.^[23]

But political interests and the will to go on with the euro project have proven stronger than the paper on which the no-bailout clause was been written. Moreover, the independence of the ECB does not guarantee that it will not assist a bailout. In fact and as we have seen, the ECB is supporting all governments continuously by accepting their government bonds in its lending operation. It does not matter that it is forbidden for the ECB to buy bonds from governments directly. With the mechanism of accepting bonds as collateral it can finance governments equally well.

There was another attempt to curb the perverse incentives of incurring in excessive deficits. Politicians introduced "managed commons" regulations to reduce the external effects of the tragedy of the commons. The stability and growth pact (SGP) was adopted in 1997 to limit the tragedy in response to German pressure. The pact permits certain "quotas," similar to fishing quotas, for the exploitation of the common central bank. The quota sets limits to the exploitation in that deficits are

not allowed to exceed 3 percent of the GDP and total government debt not 60 percent of the GDP. If these limits had been enforced, the incentive would have been to always be at the maximum of the 3 percent deficit financed indirectly by the ECB. Countries with a 3 percent deficit would partially externalize their costs on countries with lower deficits.

However, the regulation of the commons failed. The main problem is that the SGP is an agreement of independent states without credible enforcement. Fishing quotas may be enforced by a particular state. But inflation and deficit quotas of independent states are more difficult to enforce. Automatic sanctions, as initially proposed by the German government, were not included in the SGP. Even though countries violated the limits, warnings were issued, but penalties were never enforced. Politically influential countries such as France and Germany, which could have defended the SGP, inflicted its provisions by having more than 3 percent deficits from 2003 onward. With a larger number of votes, they and other countries could prevent the imposition of penalties. Consequently, the SGP was a total failure. It could not close the Pandora's box of a tragedy of the commons. For 2010, all but one member state are expected to violate the 3 percent maximum limit on deficits. The general European debt ratio to GDP is 88 percent.

The Tragedy of the Euro and the Case of Greece

The fiscal developments in Greece are paradigmatic of the tragedy of the euro and its incentives. When Greece entered the EMU, three factors combined to generate excessive deficits. First, Greece was admitted at a very high exchange rate. At this rate and prevailing wages, many workers were uncompetitive compared with the more highly capitalized workers from northern countries. To alleviate this problem, the alternatives were to (1) reduce wage rates to increase productivity, (2) increase government spending to subsidize unemployment (by unemployment benefits or early-retirement schemes), or (3) employ these uncompetitive workers directly as public workers. Owing to strong labour unions the first alternative was put aside. Politicians chose the second and third alternatives, which implied higher deficits.

Second, by entering the EMU, the Greek government was now supported by an implicit bailout guarantee from the ECB and the other members of the EMU. Interest rates on Greek government bonds fell and approximated German yields. Consequently, the marginal costs of higher deficits were reduced. The interest rates were artificially low. Greece has experienced several defaults in the 20th century and has known high inflation rates and deficits as well as a chronic trade deficit. Nevertheless, it was able to indebt itself at almost the same rates as Germany, a country with a conservative fiscal history and an impressive trade surplus.

Third, the tragedy of the commons comes into play. The effects of reckless Greek fiscal behaviour could partly be externalized to other members of the EMU as the ECB accepted Greek government bonds as collateral for their lending operations. European banks would buy Greek government bonds (always paying a premium in comparison with German bonds) and use these bonds to receive a loan from the ECB at a lower interest rate (currently at 1 percent interest in a highly profitable deal).

Banks bought the Greek bonds because they knew that the ECB would accept these bonds as collateral for new loans. There was a demand for these Greek bonds because the interest rate paid to the ECB was lower than the interest the banks received from the Greek government. Without the acceptance of Greek bonds by the ECB as collateral for its loans, Greece would have had to pay much higher interest rates. In fact, the Greek government has been bailed out or supported by the rest of the EMU in a tragedy of the commons for a long time.

The costs of the Greek deficits were partially shifted to other countries of the EMU. The ECB created new Euros, accepting Greek government bonds as collateral. Greek debts were thus monetized. The Greek government spent the money it received from the bonds sale to win and increase support among its population. When prices started to rise in Greece, money flew to other countries, bidding up prices in the rest of the EMU. In other member states, people saw their buying costs climbing faster than their incomes. This mechanism implied redistribution in favour of Greece. The Greek government was being bailed out by the rest of the EMU in a constant transfer of purchasing power.