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Politics Plays Key Role in EU's Aid Deal For Greece

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Complex political considerations are likely to play as much of a role as economic ones in shaping the details of the European Union's agreement to provide an aid package to resolve the Greek debt crisis, experts say.

Despite questions about the legality of a package, EU officials Thursday agreed in principle to extend one to Greece, a move that experts say underscores the importance of keeping monetary union intact to further Europe's larger, longer-term goals.

"The short-run concern is the Greek situation might create distress that could affect financial markets of the whole area," says Domenico Lombardi, a G7 expert at the Brookings Institution. "In the long run, there's this broader concern that letting Greece fail could jeopardize the whole idea of an ever-closer union."

While Germany may fall into the first camp, and the Netherlands the latter, "all [members] want to see a way out for Greece," Lombardi says.

Experts cite a central ambiguity in Europe, wherein economic and monetary cooperation has become acceptable, but anything else—especially on the political side—is kept at a safe distance.

"I think if you take a step back, monetary union is what keeps Europe together," says Michael Werz, a senior fellow at Center for American Progress who studied and taught in Germany before coming to the U.S. "The EU was successful as long as it was largely an economic one with a degree of the political."

That may help explain the quirkiness, even inconsistencies, of the EU. Though the union requires new members to meet rigid economic, monetary and fiscal criteria—as well as share a currency—there are no contingencies for crises such as the current one.

For all the speculation about Greece falling out of the union, there is no existing exit mechanism. The European Central Bank has no bailout authority in its charter. The ambiguity, however, is clear in emergency powers allowing financial help if a crisis warrants it.

"All those criteria were set for entry. Once you're in you're in for good," says Ram Bhagavatula, managing director at Combinatorics Capital. "In a sense all solutions are to be considered in that context."

Bhagavatula and others have compared the Greece debt crisis—as well as its probable rescue response—to the Mexican peso crisis of 1994, which was quickly addressed by a joint U.S.-IMF loan package.

"We'll give you a loan and you get your fiscal house in order," says Bhagavatula, explaining the central quid pro quo of the deal.

Unlike Mexico, however, Greece cannot devalue its currency, and some of its corrective steps are bound to have ramifications for other Euro members, particularly those with similar, though less dire, debt problems.

Though full details of the aid package won't be known until next week, EU leaders clearly want Greece to make significant budget cuts, both to address its burgeoning debt problem as well as to improve confidence in the single currency.

Some say the EU should not act and simply let market conditions force Greece's hand, which might prompt other member states with debt problems to take proactive steps, rather than get in line for a bailout.

"If Greece gets to the point where people won't take their debts and you cant pay the bills....then the Greeks ultimately have to get their fiscal house in order," says Richard W. Rahn of the Cato Institute and chairman of the Institute for Global Economic Growth. "If they do that, the crisis goes away quite quickly."

That may win praise in Brussels, but it will not win votes in Athens and elsewhere in Greece among the public sector unions as well as the country's rich whose tax burden is light compared to their European brethren.

Fiscal discipline will need a nudge from abroad and Europe's tradition of decision-making by consensus will have to be applied.

"It's going to be politically very difficult but economically it's the only way to go," says Werz. "It's important for the E.U. to set a precedent."

Experts say any EU rescue package should involve the IMF. (It's unclear at this point if the preliminary agreement does so.) A cooperative approach—rather than leaving it to the IMF, whose resources are clearly limited given Greece's projected $17 billion deficit—is likely to limit damage to the euro.

Greece is entitled to IMF support, and though the organization may not have a lot of money it certainly has ample technical and financial expertise in crafting, executing and monitoring aid packages.

"Getting the IMF involved could be a good way of dealing with the need for constraint," says Lombardi. "Greece agrees to certain policy measures and the IMF tracks the implementation."

IMF involvement also gives European leaders political cover, so the rescue package is not seen as "a takeover of Greece," says Werz. "That would strengthen right-wing nationalist parties all over Europe."

That may be all the more important if other members—Italy, Ireland, Spain and Portugal—wind up needing a bailout.

"It's the first time the sustainability of the Euro area is put at risk," says Lombardi. "It's the overall welfare of the Euro area that is a stake."