Introduction
The euro zone crisis started in early 2010 when it emerged that the Greek government had for years doctored the official data on its deficits and debt. The figures for the deficit and debt level presented by the new government were so much higher than the previous ones that rating agencies and many market participants downgraded their assessment of Greece’s ability to service its debt fully. As a result, the cost of refinancing the Greek debt increased sharply and the government could not secure the resources needed to fund its current deficit and roll over the portion of the debt coming due. By the end of April 2010 it had to be bailed out with a €110 billion programme.

The second stage of the crisis came about six months later when it emerged that the Irish government had been ‘misled’ about the scale of the losses in its banks. As the Irish government had guaranteed all the liabilities of its banks it was now itself on the brink of insolvency. Moreover (although this was not made public at the time), the ECB had become uncomfortable with the huge exposure it had to Irish banks, which had become totally dependent on central bank financing. The ECB therefore pushed the Irish government to recapitalize its banks, but this could be done only with outside help. The Irish government had thus little choice but to apply for external financial support.

With the Greek and Irish bailouts, the euro zone has shown the world two pure specimens of financial crisis: one originated by the mismanagement of fiscal policy (Greece), the other by mismanagement of a credit bubble and banking supervision (Ireland). The Portuguese crisis, which emerged in early 2011, seems to represent a hybrid specimen: a combination of a fiscal crisis (like Greece) and a private debt crisis (like Ireland).

A brief chronology
Although Greece accounts for a small portion (less than 3%) of the euro area GDP (and even less of its banking assets), in early 2010 financial markets reacted strongly to the prospect of a sovereign insolvency. A first consequence of the realization that Greece would not be solvent without external financial support was that investors started to price more widely government solvency in the bond market. As a result, the risk premia on the debt of other countries with weak fundamentals also rose. But more important was a generalized increase in risk aversion, which led to a fall in the prices of all risky assets in a similar vein (but of course a much less severe magnitude) as after the collapse of Lehman Brothers in late 2008.

The European banking sector was particularly affected because it was widely believed that a number of banks would not survive a default by Greece. However, which banks held how much of Greek debt was not known. In an environment of widespread risk
aversion and many highly leveraged banks this resulted in a drying up of parts of the interbank market, which performs a vital role in the financial system.

The German government reiterated on several occasions its aversion to a bailout, stressing that this must be only an *ultima ratio* mechanism. But when faced with the spectre of a ‘second Lehman crisis’ and the prospect of large losses in the weak German banks heavily exposed to Greece and other peripheral countries, it had no choice but to agree to a rescue package of about €110 billion. This is an EU/IMF rescue package according to which the IMF provides support under a three-year €30 billion standby arrangement (the IMF’s standard lending instrument) while euro area members pledge a total of €80 billion in bilateral loans against the implementation of strict austerity measures monitored by the IMF. The sum agreed is supposed to fully finance Greece’s remaining deficits (and rollover obligations) during the following three years. It was assumed then (on the basis of experience with ‘normal’ IMF programs) that Greece would be able to access private capital markets at reasonable rates towards the end of this period. However, in early 2011 it became clear that the hypothesis was far too optimistic. In March the terms and the conditions of the loans to Greece were reviewed to include an extension of the maturity and lower interest rates.

In the spring of 2010, Europe’s leaders also thought that Greece was a unique and special case and that no other country would ever need financial support. However, only a few days after the Greek rescue, financial markets went into such a tailspin (risk premia rose, some markets ceased to function) that a new and much larger financing mechanism had to be hastily created.

During the dramatic weekend of 9 May 2010, two financing mechanisms were set up in order to allow the authorities to react to future financial crises in a more coordinated and organized manner. The headline figure of the total potential funding was €750 billion, to be provided by three different entities: €60 billion, guaranteed by the EU budget, coming through a newly created European Financial Stabilization Mechanism (EFSM); €440 billion, guaranteed on a pro rata basis by euro area member states, coming through the also newly created European Financial Stability Facility (EFSF); and up to €250 billion from the IMF.

Together with the ECB interventions in the euro area public and private debt securities markets (Securities Markets Programme) aiming at ensuring liquidity in those market segments judged to be ‘dysfunctional’, this package did restore stability in the financial markets for a few weeks.

In early June 2010, since tensions in the interbank market persisted, member states and the European Institutions (Commission and Committee of European Banking Supervisors, CEBS) agreed to make public for the first time the results of ongoing stress tests for major European banks.¹

The rationale for the tests was to disclose information about the state of the European banking system in order to dissipate doubts about their resilience. The Spanish supervisory authorities were particularly keen on this move because they hoped that by showing that their banks were ‘safe and sound’, it would be easier for Spanish