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The Greek financial crisis

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I. Introduction

As most of you know, crisis is a Greek word with multiple meanings. The global financial crisis that erupted more than three years ago added new dimensions to the notion of crisis as it was unprecedented in its intensity, scope, complexity and duration. Moreover, the nature and focus of financial market tensions have evolved over time. The interactions between the financial sector, the real economy and public finances have created new sources of risk that pose challenges for policy-makers. Over the past year, especially during the previous six months, financial market pressures intensified in the euro area sovereign debt markets. The epicentre of the turbulence has been in the Greek government securities market with adverse effects on the Greek banking system and the Greek economy. The crisis hit home with a vengeance.

The topic of this panel discussion is the "Greek financial crisis" and I will, of course, concentrate my remarks on this topic. I would, however, like to briefly place economic developments and policy challenges in Greece within the broader context of the marked deterioration in the fiscal situation in most advanced economies and its potential implications for the economic and financial outlook.

In my remarks I will focus on four questions:

- first, what are the fiscal consequences – the fiscal legacy – of the financial crisis, the fiscal prospects in the longer run, and the challenges they pose for economic policy in many advanced economies?
- second, what are the main determinants and other contributing factors that account for the severity of the fiscal and economic crisis in Greece?
- third, what is the current assessment of the policies that have been pursued so far and of the prevailing financial market conditions? Why markets do not seem to be convinced that the economic adjustment programme will be successful?
- fourth, what are the policy challenges and the conditions for success?

II. The fiscal consequences of the financial crisis and the fiscal prospects

The financial market turbulence and the associated economic recession over the past three years have resulted in a substantial deterioration in public finances in most advanced economies. This is a known fact. But the real magnitude and seriousness of the problem and its potential longer-term consequences for the performance of our economies are not sufficiently understood or appreciated.

Various factors contributed to the worsening of public finances. The main factor was the activation of automatic stabilisers as a result of the marked contraction of economic activity which followed the collapse of Lehman Brothers. A second factor was the impact of the discretionary fiscal measures taken by many countries to stimulate their economies, following the adoption of the European Economic Recovery Plan in December 2008. A third factor was the government support to the financial sector. At the same time, because the structural government deficits of a number of countries, notably in the euro area, were

sizeable before the financial crisis erupted, fiscal deficits in those countries rose to very high levels.

As a result of these developments, the general government budget deficit in the euro area increased by more than 4 percentage points of GDP in 2009 to 6.3% of GDP, from 2% of GDP in 2008 (the first full year of the crisis). No improvement is expected in 2010 and in 2011. In both years the deficit is projected by the European Commission to remain above 6% of GDP[1]. Of course, the average figure masks large differences across countries, with the budget deficit-ratio in Greece and Ireland having reached around 14% in 2009, and in Portugal and Spain 9.4% and 11.2% respectively.

The key summary statistic that indicates the seriousness of the fiscal problem is given by the evolution of public debt relative to GDP. As a result of the persisting fiscal deficits, the public debt–to–GDP ratio will rise significantly in most euro area countries. According to the spring 2010 European Commission Forecasts, the average government debt-to-GDP ratio in the euro area is predicted to be almost 89% in 2011, which is about 20 percentage points higher than in 2008. Thus, overall, fiscal imbalances in the euro area are sizeable, broad-based and could persist, with public debt rising for some time, unless further corrective measures are implemented.

The growing fiscal imbalances and associated policy challenges are not limited to euro area economies. Indeed, in 2010 both the UK and the US are expected to have general government budget deficits higher than 10% of their respective GDP. Moreover, the debt-to-GDP ratios in these two countries are projected to exceed 90% by the end of 2011, just above the euro area average[2]. Past experience has demonstrated how difficult it is to reduce debt ratios when they reach such high levels, especially in countries where demographic factors and features of pension systems are expected to have adverse effects on public finance.

The long-term prospects of public debt dynamics appear to be dramatic given the current stance of fiscal policies, the existing pension and health care systems and the projected growing ratio of the elderly to the working age population. The potential explosive nature of the fiscal problem is illustrated by long-term projections of gross public debt relative to GDP in advanced economies over the period 2010-2040. According to the baseline scenarios, which assume that the primary balance, excluding age-related spending, improves (from the 2011 level, by 1 percentage point per year) during the first 10 years of the projection, the debt-ratios in a number of those countries reach levels between 300% and 450% by 2040.

Of course, such explosive baseline scenarios will effectively become unrealistic in the long-run, for something will have to give. Something will have to be done, sooner or later, to prevent the adverse effects of explosive public debt accumulation on economic activity and/or inflation. What is, of course, needed, and this is a key policy challenge in many countries, is the adoption of appropriate corrective fiscal consolidation measures in a timely manner, before it is too late. In this way the countries concerned will not be forced to act and take extraordinary measures as sovereign risk premia rise to very high levels, which are unbearable as they will adversely affect debt dynamics and threaten macroeconomic and financial stability.

This is precisely what happened in the case of Greece when increasing market concerns about the sustainability of public finances drove bond yields to excessive levels effectively limiting the access of the Greek government to market financing.

The main conclusion I want to draw, however, from this assessment of the fiscal consequences of the crisis in Europe and elsewhere is *not* the obvious one that Greece is not alone in facing serious fiscal policy challenges. The widespread worsening of the fiscal situation and prospects and the Greek experience itself underscore the importance of implementing credible fiscal consideration policies in a timely manner. The fact that other countries face potentially destabilising fiscal imbalances is not a source of comfort for Greece. On the contrary, it suggests that Greece will have to address its own economic and structural problems within a less favourable economic and financial environment, as the rapidly increasing public sector indebtedness in many countries is casting a shadow over the global economic outlook.

III. The Greek sovereign-debt crisis: sources of vulnerability

Let me now elaborate on the Greek sovereign-debt crisis and the economic adjustment programme. The extraordinary intensity of pressures and the rapid deterioration of conditions in the Greek sovereign-debt market has been the consequence of various factors: they largely relate to economic and structural fundamentals, but they are also associated with financial market features, concerns and expectations.

The fundamental sources of vulnerability of the Greek economy are broadly known. Increased awareness of four of these vulnerabilities and their combined impact on fiscal prospects raised concerns that debt dynamics were likely to lead to unsustainable fiscal and real income outcomes. *First*, fiscal imbalances, as assessed by both the size of the budget deficit relative to GDP and the debt-to-GDP ratio were the largest in the EU; *second*, the projected increase in government expenditure as a share of GDP in Greece over the coming decades was the highest in the EU, as a result of the existing pension and health-care systems (given unchanged policies); *third*, the significant erosion of the country's international competitiveness, which has implications for economic performance and the government's capacity to raise tax revenue; and, *fourth*, the low credibility of fiscal statistics and government fiscal forecasts that greatly increased uncertainty about the actual magnitude of the fiscal problem and raised doubts about potential fiscal outcomes.

Underlying those key sources of vulnerability, there were deeper, more fundamental, determinants of poor fiscal performance: the inefficient functioning of the public administration and, more broadly, of the public sector, and the implementation of fiscal and labour-market policies which were not compatible with the requirements of the European monetary union and the stability-oriented policy of the ECB. The conduct of economic policy was often influenced by short-sightedness and political-cycle considerations, and was supported by the belief that deficit financing would always be available and at low cost, regardless of the level of the government's overall indebtedness.

In addition to those factors, developments in the Greek sovereign-debt market were influenced by market features and expectations. *First*, the remaining maturity structure of

Greek government debt was relatively short and unevenly distributed over time. *Second*, the very high share (about 70%) of total government debt held by non-resident investors. *Third*, market sentiment and expectations were adversely affected by increasing concerns about the sustainability of public finances associated with the perception that the country would be unable to bring its public finances under control in the longer run.

The effects of all these factors, as well as of others that I have no time to touch upon, combined and progressively resulted in raising the cost of market funding and the CDS spreads to levels that were unbearable in the sense that they would make impossible the achievement of the fiscal consolidation objectives.

IV. The economic adjustment programme:Current assessment and market response

The economic adjustment programme of Greece aims at simultaneously achieving fiscal sustainability and restoring international competitiveness, in terms of both price and quality. To this end, it involves a very substantial fiscal consolidation, so as to reduce the budget deficit by 10 percentage points of GDP by 2014, and a comprehensive set of reforms to address the major and persisting structural weaknesses of the economy. The programme is ambitious but feasible. It is based on conservative macroeconomic assumptions and it is frontloaded. It is also subject to strong conditionality that relies on a thorough quarterly monitoring and assessment by the European Commission, the ECB and the IMF.

The measures that have been implemented so far are significant, courageous and absolutely necessary in order to halt the slide into the abyss of unsustainable debt dynamics and further competitiveness losses that inevitably would have had disastrous effects on economic activity and employment. The policy actions taken, and others under way, are fully in line with the programme's requirements and can be expected to result in the attainment of the set objectives for 2010. However, the pace and effectiveness of implementation of some measures can be improved.

The steps that have been taken to reduce the budget deficit this year by almost 6 percentage points of GDP have unavoidably had a strong negative impact on real incomes, particularly of public sector employees. This development has to be seen in the light of an increase in nominal salaries in the public sector by more than 100% over the previous ten years, compared with a much lower average salary increase in the euro area countries over the same period. These higher public sector wages were provided by a state lacking sufficient own resources and relying on borrowed funds, as long as the lenders were willing to finance the growing government debt. A painful adjustment of real incomes would have been inevitable in any case when debt accumulation threatened to become unsustainable and lenders became unwilling to fund imprudent fiscal practices.

A very important part of the economic policy pursued involves the implementation of structural reforms. In particular, the pension reform adopted in July addresses both the medium and long-term challenges of the pension system, which were a main source of concerns about the sustainability of public finances in Greece, one of the key vulnerabilities I referred to earlier. The significance of this reform has not been sufficiently

appreciated. Other reforms to enhance the credibility of statistics, the effectiveness of the tax system, the efficiency of the public sector and the competitive functioning of markets are also very significant. When fully implemented these reforms will address the other key vulnerabilities and market concerns. It is absolutely necessary that decisive steps be taken to ensure that the new legal and institutional frameworks result in concrete and visible improvements. Having said that, I want to stress that the progress made on the reform front in such a short period of time is remarkable.

Nevertheless, financial markets are not yet convinced that the economic programme will be effectively implemented over its three-year horizon. This is reflected in the sovereign-bond and CDS markets, where spreads have remained at exceptionally high levels. It is also reflected in the recurring suggestions or predictions that debt-restructuring is necessary or unavoidable. Of course, conditions in the Greek sovereign debt market are influenced by certain structural factors and the credit assessments of rating agencies. But market participants have expressed concerns about a number of risks that in their view are not immaterial. What are the perceived persisting or emerging risks in the eyes of market participants? What are the necessary conditions for the successful implementation of the programme in the coming years and improved prospects for market financing?

Market concerns include:

- the risk of a sharper contraction of economic activity than assumed in the programme, with adverse effects on fiscal deficits and debt dynamics;
- the risk of political tensions and social unrest that will threaten the implementation of further reforms;
- the risk of surprises concerning the size of government debt obligations, especially in the wider public sector;
- the projected increase in the debt-to-GDP ratio over the medium-term, even under the baseline scenario, and the time profile of maturing government debt, which could entail challenges for the debt's refinancing.

Other risks and uncertainties have also been noted. These concerns cannot be dismissed *a priori*. But the significance of these risks and the likelihood that they will materialise are overestimated. Solid arguments can be advanced to support this view.

V. Economic prospects and policy challenges

More importantly, continuous, consistent and effective policy implementation is the key to addressing persisting market concerns. As the fiscal situation improves, structural change enhances growth prospects, and policy credibility increases, conditions in the sovereign debt market will improve significantly. A better use of the assets owned by the public sector can also contribute to the reduction in gross public debt, easing concerns about the government's future borrowing requirements. All these developments will facilitate the financing of the Greek banking system and the real economy.

So far, policy implementation is broadly on track. Fiscal and economic outcomes are also in line with the baseline scenario. There are some developments, however, that require careful assessment and effective policy response. The observed tax revenue short-fall relative to the target, which reflects the effects of several factors, requires close monitoring. Ensuring that tax revenue increases in line with the policy targets, by speeding up the reform of the tax system and strengthening the mechanisms for tax compliance, is essential both for achieving the targeted deficit reduction and for reasons of social justice.

A top policy priority is to enhance the economy's growth potential and establish conditions that can support a higher pace of economic activity and job creation in a sustained manner. This is the ultimate objective of the economic adjustment programme. Every effort should be made to achieve it sooner rather than later, as this will strengthen real income, facilitate fiscal consolidation and increase public confidence about the economic prospects.

The key to achieving high sustained growth and improved living standards is the implementation of reforms that can make the Greek economy competitive in global markets. Simple economic logic and the experience of countries, both large and small, that have prospered by being able to compete successfully in world markets support this view. The poor competitiveness record of the Greek economy speaks for itself. It is high time that the necessary reforms are implemented to restore competitiveness, increase the export orientation of the economy and attract foreign investment to expand the necessary infrastructure. The policies and reforms of the economic adjustment programme will contribute to this end. But more actions may be necessary -both in the public sector and the private sector- to foster innovation and install more dynamism in the Greek economy. In this area too, effective implementation of the appropriate reforms and policies is needed to ensure that plans are translated into actions.

Fiscal consolidation and growth-enhancing policies are not incompatible. On the contrary, they can be mutually reinforcing, provided that the appropriate policy instruments are used and the failed policies and practices applied in the past are abandoned. Indeed, the adoption of reforms to improve the country's competitiveness and increase its economic growth potential can yield positive synergies between measures aimed at restoring sound public finances and policies aimed at supporting job creation and income growth.

VI. Concluding remarks

To conclude: The successful implementation of the economic adjustment programme is not only possible, it is very likely. The far reaching and comprehensive nature of the programme, the decisive actions taken so far, the commitment of the government to fully implement it, the lessons learned from the crisis, the public understanding that inappropriate policies and market practices can not continue, the monitoring, assessment and support by the EU and the IMF, all these factors should ensure that the policy objectives will be met and the economy will recover to a sustained path of higher growth and better living standards. Success is therefore the only option, the only envisaged outcome of the economic adjustment programme, first and foremost for Greece but also

for the euro area. We should, however, not forget that the outcome will essentially and ultimately depend on the actions of all of us. Put differently and paraphrasing Julius Caesar: "the outcome, dear Brutus, does not depend on the stars, but on ourselves".

[1] According to the latest available spring 2010 European Commission forecasts.

[2] The projected increase in the debt-to-GDP ratio is especially large in the case of the UK: 44 percentage points in the four-year period 2007-2011.