Greece, the Eurozone, and the Debt Crisis

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1 Introduction

The central cause of the Greek crisis is the decline in competitiveness that Greece suffered ever since its accession to the Monetary Union by its adoption of the euro since 2001. It is perhaps harder to see that because of stellar growth performance of the Greek economy more or less since the mid 1990s and up till the emergence of the Great Recession of 2007. See Figure 1. But Greek economic growth was simply not sustainable, because Greece lacked (and failed to develop) the institutions needed to sustain growth, namely the improvements in education and investment in research and development and massive investments in infrastructure. Its legal system is archaic and provides disincentives to foreign investment and indeed to all economic activity [Papaioannou (2011)].

Monopolistic structures, oligarchic labor relations favoring certain groups of the labor force and lack of any deliberate effort to contain costs and implement structural reforms led to rapid increase in unit labor costs, making Greece one of the most expensive countries to produce in the European Union. See Figures 2 and 3. This growth of nominal unit labor costs was pronounced since 2001, to 2010, but the forecasts for the period 2011 2012 do show a negative growth which is well below the respective one for the Eurozone.

The contemporary view on growth emphasizes the central importance of total factor productivity growth, namely growth of the economy over and above what can be explained by the growth of the measured inputs. Table 1 compares GDP growth and total factor productivity growth (TFPG) for Greece, Portugal, Ireland, and Italy. While TFFG for Greece lags behind that for Ireland, it outperforms Portugal and Italy, during 1995–2003, but it lags behind of all these countries over 1986–1995.

2 Greek Overconsumption during 2001–2008

European interest rates both declined during the first decade of the 21st century, following the introduction of the euro, and converged to one another during that same period. These dramatic outcomes are shown in Figures 4 and 5, respectively. The Greek government

took advantage of those historically low interest rates to borrow in order to finance transfer payments and pensions as well as a bloated public sector. As Figure 5 details, although spreads shrunk considerably, they did allow banks to borrow in effect at German interest rates and lend at a profit to such peripheral EU countries as Greece, Spain, and Ireland.

That this has been associated with overconsumption is clear from Figure 6. The larger is the average, over 2001–2008, private and public consumption as a share of GDP, the larger is the current account deficit. Interestingly, while Greece and Portugal are "bad" outliers, Ireland is a "good" outlier.

What emerges from these developments is that The EU North was saving more than the EU South. More specifically, as Figure 7 details, Greece having been an exceptional saver in the early 1970s, became the greatest dissaver by 2009. Ireland, on the other hand, improved its saving performance from the late 1980s, when it was considered a problematic economy, to the late 2000s, when its was the star performer.

It clearly appears to be a solid feature of the Eurozone that the capital-rich North is lending to the capital-poor South. The key question here is whether this is inevitable. The present writer believes that it is not and cites the example of Finland, whose economy was comparable to the EU South until the last fourth of the 20th century. If the EU South had developed, it would be running trade surpluses from selling to the North, which is definitely true of Finland and of Ireland prior to the onset of its crisis — a crisis that is very different from that of Greece and Portugal. This contrasts with an argument, frequently presented, that the North retains its first-mover advantage. Yet, trading relations depend on comparative advantage, a very powerful economic force: all a country needs is to be relatively better, relatively more efficient in certain activities. Of course, this is necessary but not sufficient. Economic geography has taught us that clustering of activities is also very important.

3 Greek Public Sector Deficits and Debt

The current condition of the extreme indebtedness of the Greek economy has not developed overnight. As Figure 8 details, a steady increase in deficits, which were run by the two PASOK governments of the 1980s and hit a peak of 15% in 1990, contributed to an increase of gross debt as a share of GDP from 20% in 1981 to nearly 100%, by the time PASOK returned to power in 1993. From then on and in spite of some effort by successive Greek governments to meet the Maastricht criteria for the deficit and the debt, Greece did not succeed. It was always the most problematic among the EU members aspiring to accession to the EMU.

An analysis of the cumulative debt over 1990–2009 by Moutos and Tsitsikas (2010) shows that nearly two-thirds of it were associated with new obligations by the Greek government, such as assumption of losses and debt of public corporations, Olympic Games spending, social spending. That is, mostly public consumption, and not investment. This is also confirmed by Figure 9, that shows the cyclical component to be very small and of vanishing influence.

Overall, as Figure 10 shows, a considerable portion of the debt is held by Greek banks. Specifically, as of mid Fall of 2011, of a total of 366 Billion Euro, the EU countries and the IMF held 78 Billion, the European Central Bank 62 Billion, and the remainder was held by the private sector, 202 Billion. Of this, Greek banks own about 50 Billion, Greek pension funds about 30 billion, and Greek insurance companies about 4 billion. This underscores the urgent need to recapitalize Greek financial institutions, too, if debt renegotiations currently under way result in a substantial "haircut."

4 What went wrong since the May 2010 Agreement with the Troika?

As evidenced by the latest report (October 2011) by the Troika, reforms stalled and the Greek economy is in deep recession. What we can say about the program design and outcome is that its designers ignored and/or neglected major rigidities and dysfunctionalities (economic and political) in the Greek economy. The population never took *ownership* of the program. Then, expectations collapsed, investment and private initiative collapsed, and the Greek economy has experienced a decline in national income of nearly 20% over three years since the beginning of 2009.

The numerous inflexibilities and dysfunctionalities of the Greek economy and society are all factors that prevent smooth adjustment to a lower price and wage level, and their role was not properly anticipated. Note that decline of wages does not leave workers worse off if prices also decline at the same time. But things cannot always be so uneventful. Many individuals and firms face financial obligations that are nominally fixed, in which case reduction of nominal incomes would force some people into severe financial distress.

The Troika has also operated under the assumption that fiscal consolidation is compatible with economic growth, precisely because it may encourage investment. Still, a recent very careful study conducted by IMF economists show that a 1% of GDP fiscal consolidation reduces real private consumption by 0.75% within two years, while real GDP declines by 0.62%. In particular, even large spending-based fiscal retrenchments are contractionary, as are fiscal consolidations occurring in economies with a high perceived sovereign default risk. So, it looks like the IMF is finding out that the medicine was not well researched. Years of neglect of long-overdue investments activities promoting education and research, that are badly needed to prepare Greece's labor force for a competitive world economy, are taking their toll.

4.1 How to Move Forward?

The only way forward is vast reduction of the wasteful and bloated Greek public sector coupled with dramatic new measures to restore confidence and improve competitiveness. As Azariadis, Ioannides and Pissarides (2010; 2011) detail, confidence can be restored internally and externally, only if things are done in Greece that have never been done before. This also agrees with numerous public pronouncements by officials of the European Commission and the IMF, and to an encouraging extent with part of Greek public opinion, as well.

But we all acknowledge that even with the internal devaluation that stabilization program for Greece rests on, it will take a long time and very high growth rates for the Greek economy to recover. The debt burden is enormous. The original lending programs included punitively high interest rates, a fact that has been recognized in the latest round of agreements. Specifically, in the Agreement of October 26–27, 2011, central role is played by an effort to secure the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020. "Euro area Member States will contribute ... up to 30 billion euro. The nominal discount will be 50% on notional Greek debt held by private investors. .... A new EU-IMF multiannual programme financing up to 100 billion euro ... accompanied by a strengthening of the mechanisms for the monitoring of implementation of the reforms. ... A significant strengthening of economic and fiscal coordination and surveillance. ... A set of very specific measures, going beyond and above the recently adopted package on economic governance, will be put in place. ... [and] Ten measures to improve the governance of the Euro area."

This promising set of desiderata has been difficult to implement. as of this writing [January 28, 2012], Greece and representatives of its creditors via the Institute of International Finance are locked up in acrimonious negotiations, with support from the IMF and Eurozone government leaders arguing in favor of lower interest rates. Press reports suggest that the IMF favors official debt relief. And a critical issue in the negotiations is whether or note the European Central Bank will also be required to incur a haircut. The latter possibility poses critical issues for the entire Eurozone, because a haircut of the magnitude being talked

about would wipe out ECB's capital, prompting member governments to recapitalize it.

5 Official Debt Relief is Necessary

I have argued, somewhat hesitantly originally but increasingly firmly more recently, that Greece will not be able to sustain a recovery without official debt relief. To see this, we need to go back to the early beginnings of European economic integration. Considering the broader political and historical context leads us to what was the burning question in 1945, how to avoid another world war. Questions like "Who was responsible for World War II" gave way to "How to avoid mistakes of the end of World War I." Many answers are possible, and it is not my subject, but among the solutions proposed were: (a) Morgenthau Plan -0 "Neutered Germany"; (b) Communism; (c) European integration as a restraint on Germany. European economic integration, largely successful (save for the monetary part) by now, was not at all a certainty when it was first conceived in the late 1940s.

Yet, at the very foundation of European post World War II recovery and the very inception of European economic integration is a number of key financial decisions by the US, which completely reinitialized Europe's economies. After World War II, US forgave French World War II debt, while Britain paid off its Lend/Lease debt to the US completely (and very expensively). In 1953 *all* of Germany's creditors forgave German debt. US forgave German pre-World War II debt. The adjudication, if any, of Greek war reparations are shrouded in secrecy, but it looks like Greece did not press any claims after the reunification of Germany in 1990.

Writing in the *Guardian*, July 5, 2011, the eminent historian Mark Mazower argued that "the members of today's political class in Europe are Margaret Thatcher's heirs, not George Marshall's. ... They find it hard to understand that the markets need to be saved from themselves if Europe is to survive in anything resembling its present form. ... They forget that Germany itself was allowed to cancel its prewar debts in 1953, one of the preconditions for its subsequent boom. ... Poland in 1991, [was] allowed to write down their debts ... and they too prospered.

In effect, Mazower posed the need for a *New Marshall Plan* For Europe. The numbers are interesting. The original Marshall Plan amounted to $ 13 Billion, or roughly 5% of US 1948 GDP. This is to be contrasted with the fact that the total debt of Greece, Portugal and Ireland is about 4.5% of EU GDP. In other words, in the same ballpark as the Marshall Plan!

The Marshall Plan was of course a political project. Now, should EU peripheral country debt be written off? What are the intentions of European electorates? What should European electorates do?

Pressures for official relief also come from unexpectedly unwitting "bedfellows." Former German Chancellor Helmuth Schidt has been reminding German audiences that the German *Wirtschfastwunder* became possible only because of the official debt relief. Nationalists and other groups in Greece are dusting off old claims for unpaid reparations. Under the title "Does Germany Owe Greece 70 Billion Euro?" *Die Welt*, September 17, 2011 argued in favor of this claim. It is clear that for a number of political and geopolitical reasons that are not fully known as of now — and are certainly not the expertise of the present writer — Greece seems to have neglected its claims of reparations from Germany, including the forced loans and requisitions of goods during the World War II Axis occupation of Greece.

Whether or not such claims might be officially sanctioned, the writer's opinion is that one way or another Germany will at the end provide substantial assistance to Greece, provided that Greece truly undertake reforms which are necessary for its survival in the EU, let alone in the Eurozone.

6 What Needs to Be Done

The present writer believes that Eurozone should do nothing unless unless Greece is placed under virtual receivership and be guided in its overhaul of its public sector. The Agreement of October 26–27 talks of "Monitoring Capacity on the ground," which presumably will be part of the new loan agrement, if indeed the different parties get that far. In addition,

Greece needs to amend its constitution in order to facilitate thorough overhaul education and labor union law, shrink and rationalize public sector, and in the immediate future prosecute egregious embezzlers of public funds and other eliminate all kinds of corrupt practices. The latter had made Greece fall below African countries in terms of corruption, as reported by *Transparency International*. See Figure 11.

Recall that the US union works in part because of federal authority in prosecuting criminals and other transgressors. Rod Blagojevich, the former governor of Illinois, who is imprisoned for fourteen years, has been convicted for merely hinting that he would have be rewarded for appointing a particular individual to succeed US Senator Obama after his election to the US Presidency.

And, of course, unless growth starts, nothing will happen.

7 Azariadis, Ioannides, and Pissarides "17 Proposals"

As originally published in *Kathimerini*, October 12, 2010, and is available in more detail at `http://greekeconomistsforreform.com/wp-content/uploads/A-I-P-DEVELOPMENTw.-abs-10-06-10.pdf` propose a number of quantified proposals which they think will allow Greece to escape its current predicament and launch itself on a path of sustained growth. They recall that in 1981, Greece, with a per capita income of 9,080 Euro, was very comparable to Finland and Ireland, whose respective per capita incomes were 9,770 and 6,170. In 1994 Ireland surpasses Greece. Finland was at that time already ahead of Greece (in spite of Finlands "Great Depression," 1990-94). In 2008 Greece stood at 29,290., Ireland at 37,440 and Finland at 37,820 euro per capita.

These accomplishments were made possible by the development of economic and social forces. Greece needs to emulate Finland, modernize its institutions, by improving education, health and research and development, and the rule of law, and thus become more competitive. The choice for Greece is between *virtue* and *vice.* A virtuous path will make Greece a Mediterranean Tiger. "Vice," on the other hand, will be underscored by poor public services,

persistent tax evasion, inequality, poverty, social unrest, a political life ruled by an oligarchy of special interests associated with labor unions and numerous corrupt practices.

8 Is This Possible?

However exotic a prospect this may appear at present, the present writer along with his collaborators Costas Azariadis and Christopher Pissarides and their other colleagues on `GreekEconomistsforReform.com` firmly believe that it is indeed possible. There exist a number of favorable factors. Yes, there exists a huge public debt, but Greek households and firms are not overdebted. Private loans at only 110% GDP are small by EU standards. Private debt at only 81% GDP plus a lot of private wealth (that generally and scandalously evades taxes) is also notably. A Eurobank study shows internal devaluation would be most important for manufacturing and agriculture, and not to the same degree by the entire economy. These factors along with generous international assistance, plus some official debt relief, plus the implementation of real reforms can make it possible.

In addition, the EU-wide austerity that Germany demands is clearly counterproductive for the following simple reasons, that Paul Krugman has talked about repeatedly. Namely, the nature of the EU as an entity vis--vis rest of the world makes it fairly closed economy. Consequently, there are no leakage in the implementation of fiscal policy, which would work to stimulate all EU economies, allowing them to reduce their dependence on increased taxes, which act as a drag. Austerity in Germany to avoid inflation has the effect of reducing imports from the South, which in turn reduces income in the South and thus reduces imports from Germany reducing income there. There is a vicious cycle through inherent fiscal interdependence of the EU countries. A little inflation in the North would have made it much easier for Greece, along with the right policies, to keep its unit labor costs growing more slowly than in the North.

9 How about Reform of the Eurozone Itself?

The present author thinks that the problems facing European integration at the moment may not be resolved without political union. While even energetic pursuit of European integration would not yield immediate fruit, a number of design issues need attention. De Grauwe (2011) has drawn attention to an inherent design problem in the eurozone. With a national currency, when a country borrow in its own currency to carry out fiscal policy, experiencing loss of credibility leads to currency depreciation which improves competitiveness, while currency does not leave economy, and liquidity does not fall. In contrast, when a eurozone member borrows in effect it is like borrowing in a foreign currency: its borrowing costs (in Euro) go up, but there is no improvement in competitiveness. A risk of a self-fulfilling prophecy appears: Increasing interest rates, worsening deficits, taxes rise to close the deficit, income declines. The country is trapped in high-yield, low-borrowing area of its demand for borrowing. This entrapment is prevented only if there is assistance from the union without need to negotiate it in each case, and the markets know it.

Similarly, a fiscal federation works to stabilize the federated economies, by transferring income automatically between states when one is doing well and another badly. The US federal fiscal system provides automatic, mechanical transfer of income across its subeconomies, the economies of different states, and markets know it. Of course, a fiscal union requires substantial political integration.

Have European leaders recognized this? The Agreement Oct. 26–27, 2011, No. 25. p. 7, states: "Being part of a monetary union has far reaching implications and implies a much closer coordination and surveillance to ensure stability and sustainability of the whole area. The current crisis shows the need to address this much more effectively. Therefore, while strengthening our crisis tools within the euro area, we will make further progress in integrating economic and fiscal policies by reinforcing coordination, surveillance and discipline. We will develop the necessary policies to support the functioning of the single currency area.

Unfortunately, this falls far short of endowing ECB with a mandate to act as lender of last resort and guarantor of financial stability, as well, not price stability. The new European

Financial Stability Facility (EFSF) and its successor, the European Stabilization Mechanism (ESM) is regarded by many economists as a strange institution. Economists unhappy with the fundamental design of the EMU are still unhappy.

So without serious steps towards fiscal union the Eurozone will fail. In addition, the EU institutions need real legal "teeth." E.g., the EU Court of Auditors must acquire real teeth, which necessitates changes in the treaties etc. which would criminalize certain activities at the EU level. EU members should not be allowed to get away with diverting funds. Investment means investment: governments should not get away with diverting their use of EU resources. In Greece, EU resources functioned like petrodollars in petroleum-rich countries, being diverted to consumption instead of investment.

10 Conclusion

So, where are we? The Troika did not, it is now clear, anticipate such as a sharp contraction. What could have happened instead? If the government were to reduce deeply wasteful spending, it should at the same time have promoted small and large investments, either by shifting spending that it could afford to keep and/or by drawing on EU resources, by cutting red tape and giving sharp incentives to individuals, that have already been allocated to Greece. Social strife and party politics made it hard for the government to rationalize its activities and a highly politicized, unwieldy and inefficient government bureaucracy that continues to resist effort to shrink it did not help.

The world expected Greece to acknowledge the serious difficulties and tackle the crisis right away. As several of us have argued elsewhere repeatedly, the world needed to see things in Greece that have not been seen before, a new Greece, which itself would have helped boost confidence internally, as well. Egregious tax evasion going unpunished causes further erosion in the government's credibility as it tackles its deficit problem. Greece new prime minister is a breath of fresh air, at the top, and a steady force in favor of a rational approach to the enormous problems facing the country. Unfortunately, we are hardly seeing party politicking diminishing, which at this juncture is indeed toying with disaster by party bosses, hitherto

essentially "unreconstructed" fanatics who fail to see how responsible they are for Greece's looming demise.

With the same fundamentals, meaning its people, its machines, its knowledge, its resources, an economy can move up, down or stay the same. If Greece had its own currency, manipulating the currency can provide a nudge, but unless expectations also move, changing the currency can end up in inflation, that would offset the effect, at the very minimum. Greece does not control its currency, and as a result money must come into the country to pay for the difference between what we want to import and what we export, and for the government to finance the excess of its spending over its tax revenue. Confidence in the future and pursuit of productive investments is the only way to reduce those twin deficits in the long run, thus increasing income and thus tax revenue and by increasing exports more than imports. Even if we had our own currency, it would be worthless if we did not believe in its value.

Greece's best option at the present juncture lies in making possible for itself to stay in the Euro and thrive. It will be long and painful, but there really is there no other palatable alternative, politically and socially for Greece.

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Growth Rates: Greece and EU-15

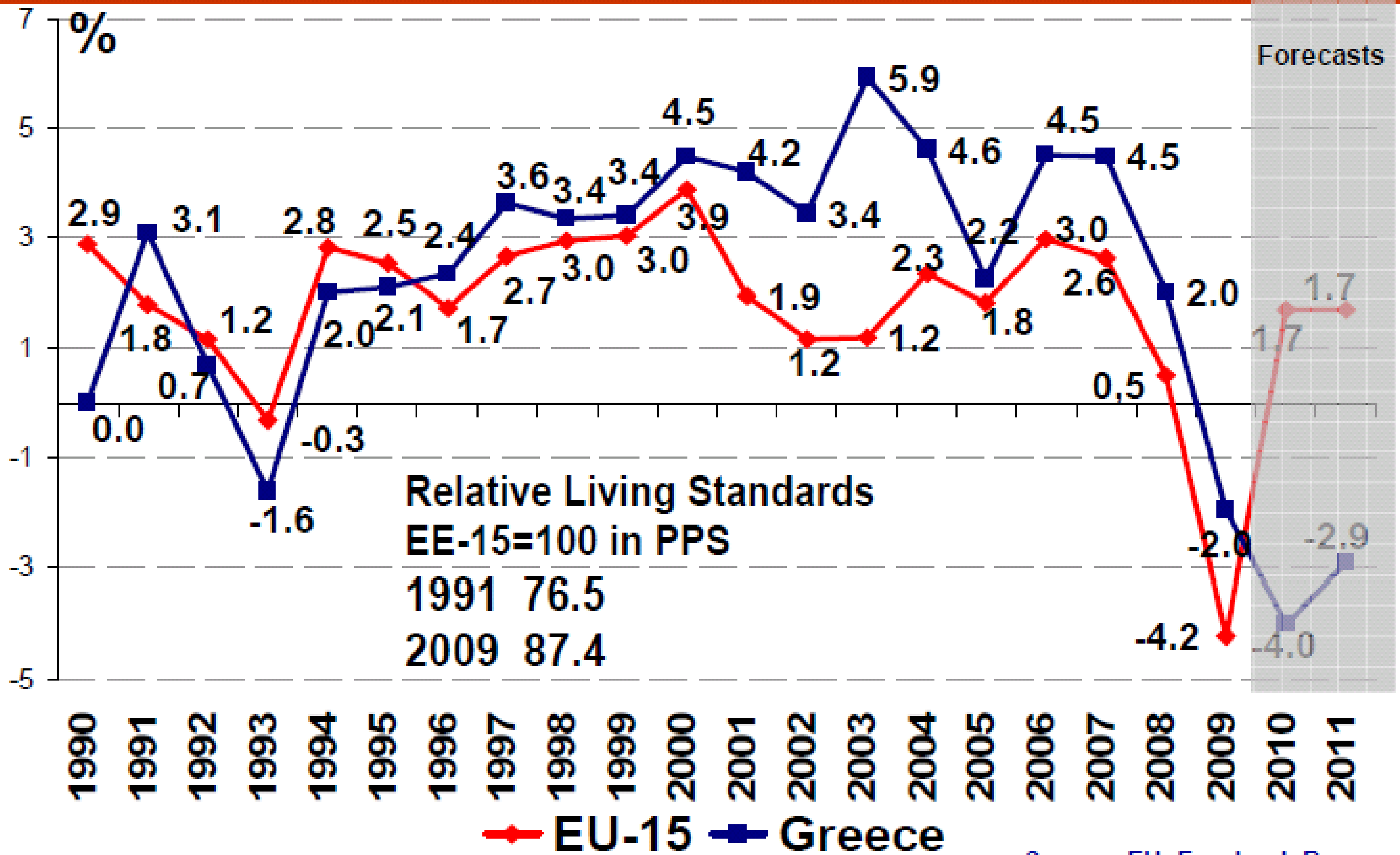


FIGURE 1

Unit Labor Costs – Eurozone 1980 - 2007

ULC

.8
.6
.4
.2
0

1980
1983
1986
1989
1992
1995
1998
2001
2004
2007

AUT BEL FIN FRA GER
GRC IRL ITA LUX NLD
PRT ESP

Working Paper No. 651

Unit Labor Costs in the Eurozone: The Competitiveness Debate Again*

by

Jesus Felipe
Utsav Kumar
Asian Development Bank, Manila, Philippines

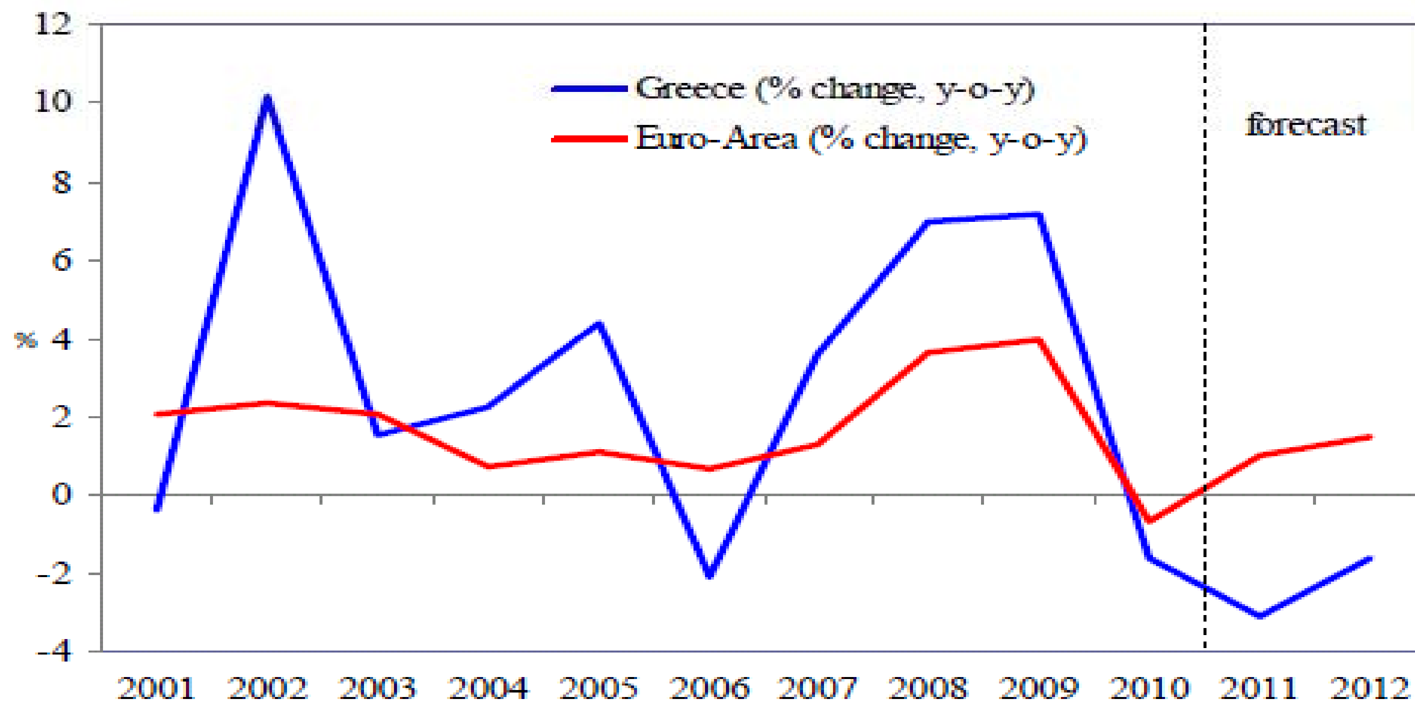
February 2011

Source: OECD and authors' estimates
Note: AUT-Austria, BEL-Belgium, FIN-Finland, FRA-France, GER-Germany, GRC-Greece, I
ITA-Italy, LUX-Luxembourg, NLD-Netherlands, PRT-Portugal, ESP-Spain

FIGURE 2

Growth of nominal unit labor costs to 2010

and EU forecast 2011 – 2012



(% change year-on-year of unit labor costs)

FIGURE 3

GDP Growth and Total Factor Productivity Growth: Greece, Portugal, Ireland, Italy

Total Factor Productivity Growth

- Data from Antonakopoulos and Sakellaris, *Information Economics and Policy* 21 (2009) 171191.

GDP Growth rate versus TFP Growth, 1986–1995, 1996–2003
Greece, Portugal, Ireland, Italy

	86–95 GDP	86–95 TFPG	96–03 GDP	96–03 TFPG
GR	1.428	-.136 , -.410	3.672	1.346 , 1.106
PT	2.985	1.489	2.525	.395
EI	5.478	3.723	7.989	3.552
IT	1.827	0.806	1.549	-.346

TABLE 1

After 2001 the Eurozone brought low interest rates for Greece: 1998-2009

Bond Yield Greek Gov't 10 yr– Euro 10 yr (GECU10YR) __ http://www.fullermoney.com/content/2009-01-19/greece.png

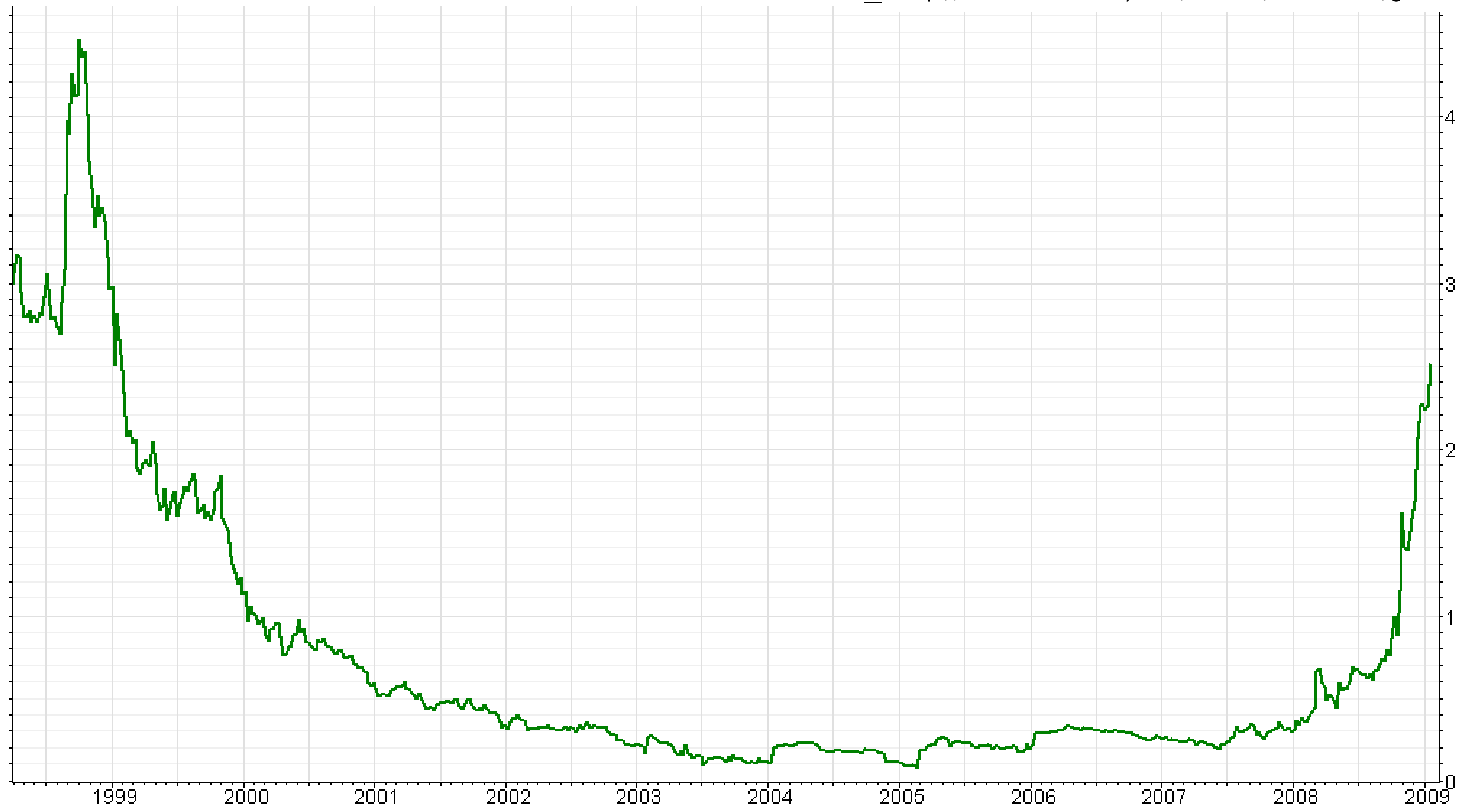


FIGURE 4

Not just Greece:
Euro-Zone 10-year bond yields 1992-2011

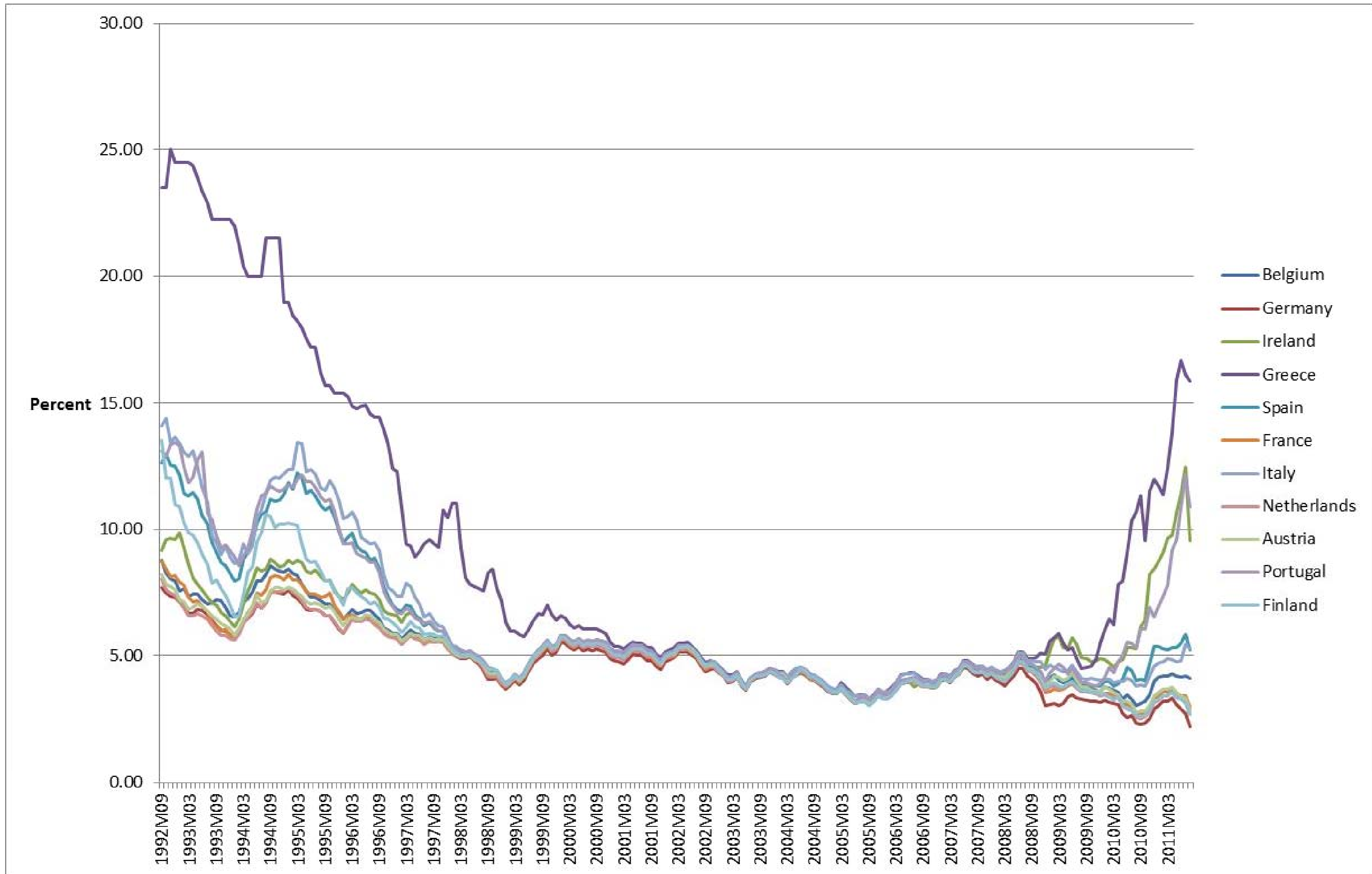


FIGURE 5

Consumption and the Current Account Balance:

The EU North was saving more than the EU South

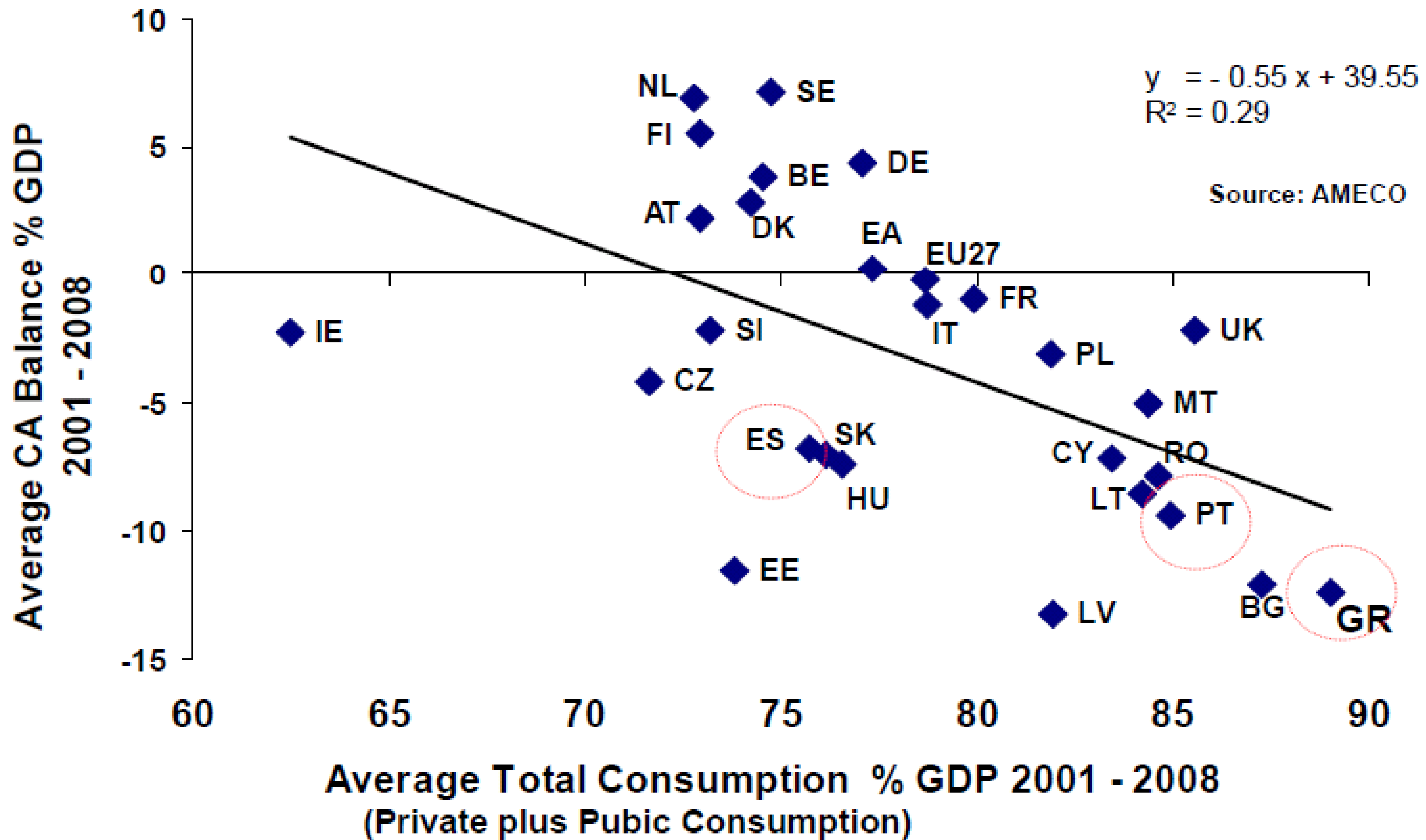
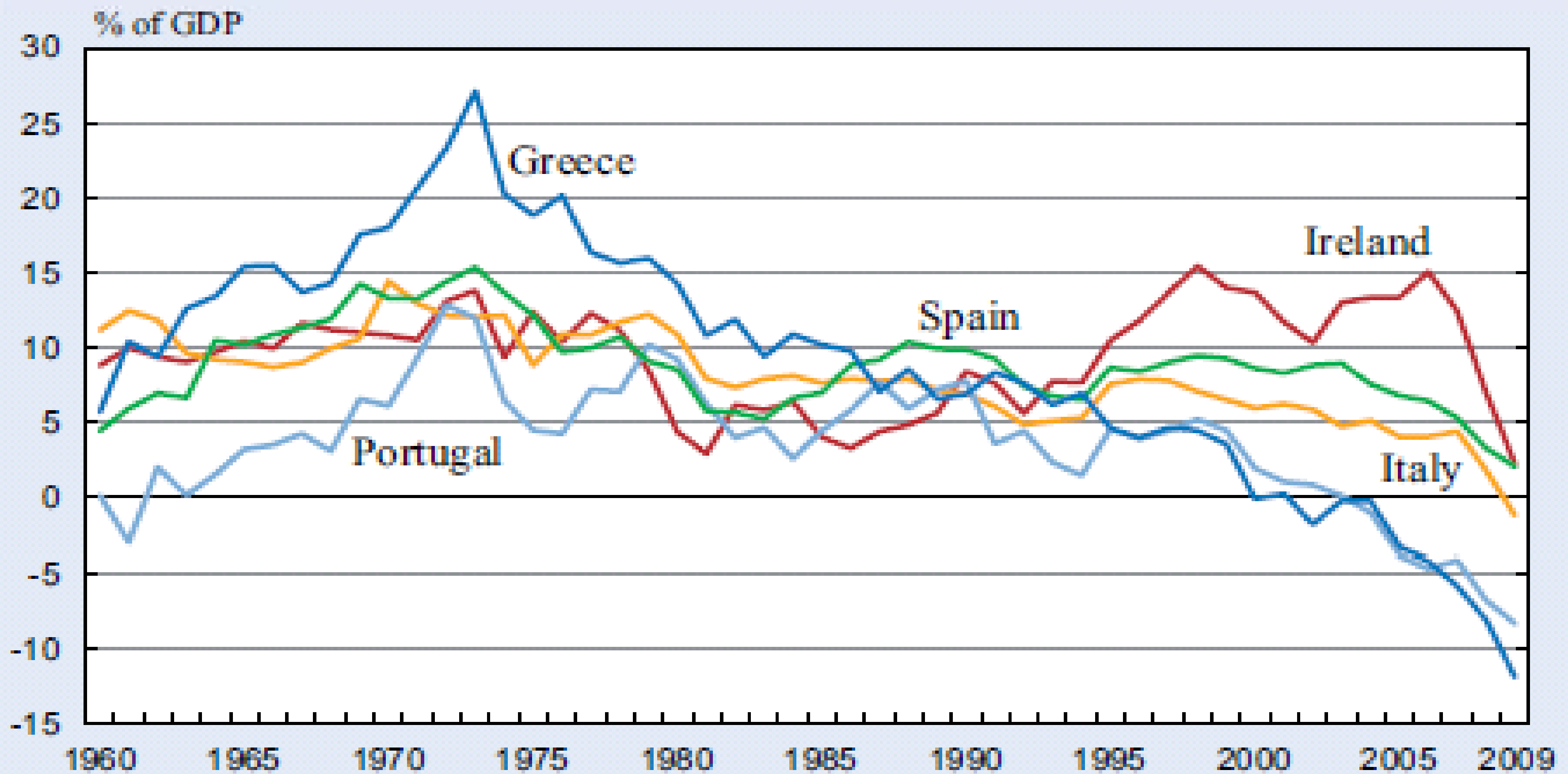


FIGURE 6

Savings declined in the EU South – and particularly in Greece



Source: Ameco: Capital Formation and Saving, Total Economy and Sectors, Net-Saving, National (USNN), ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, data extracted on 11 January 2011; own calculations.

FIGURE 7

Greek Deficits and Debt: 1974-2010

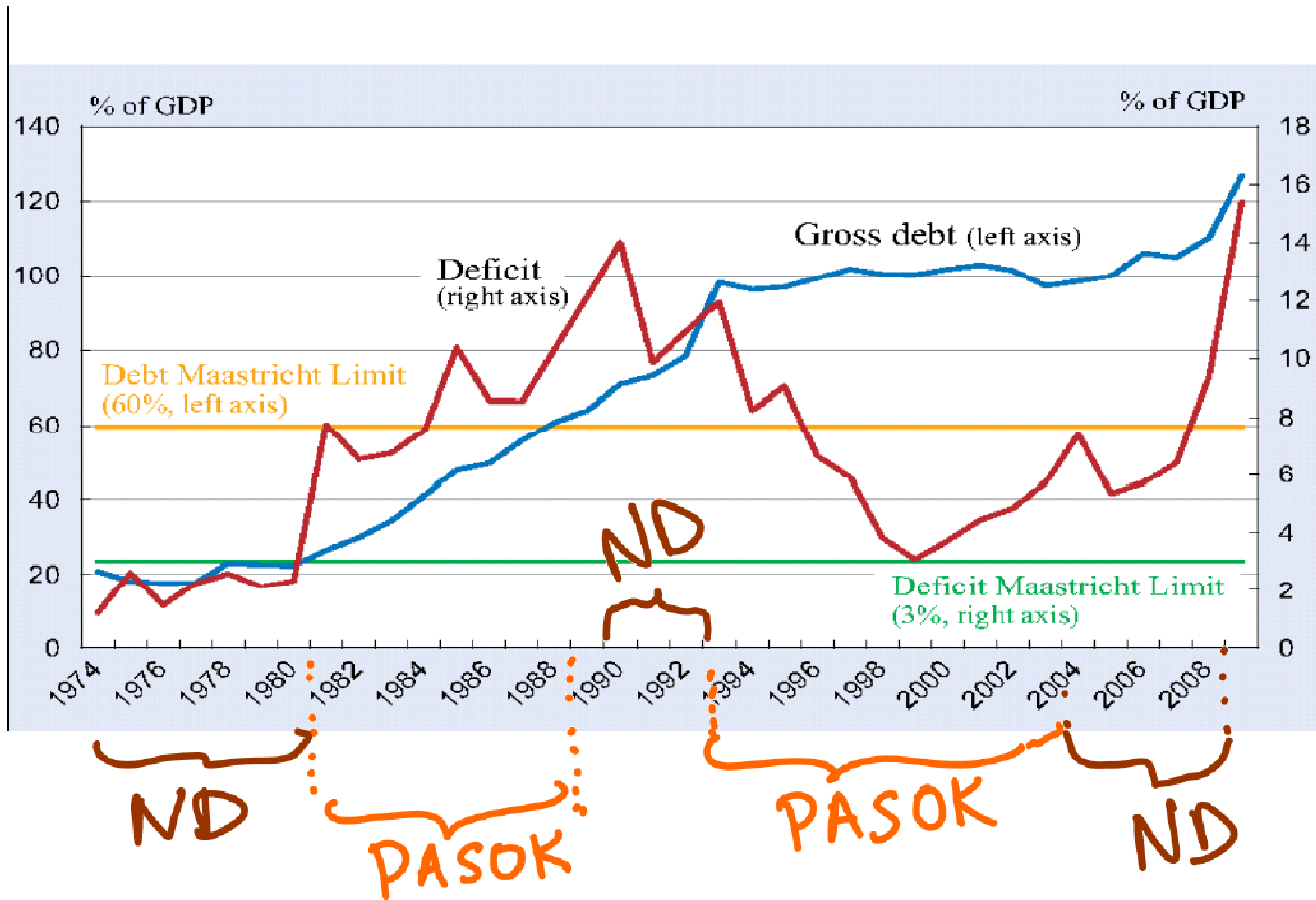


FIGURE 8

What does increase in public debt reflect? 1990—2009

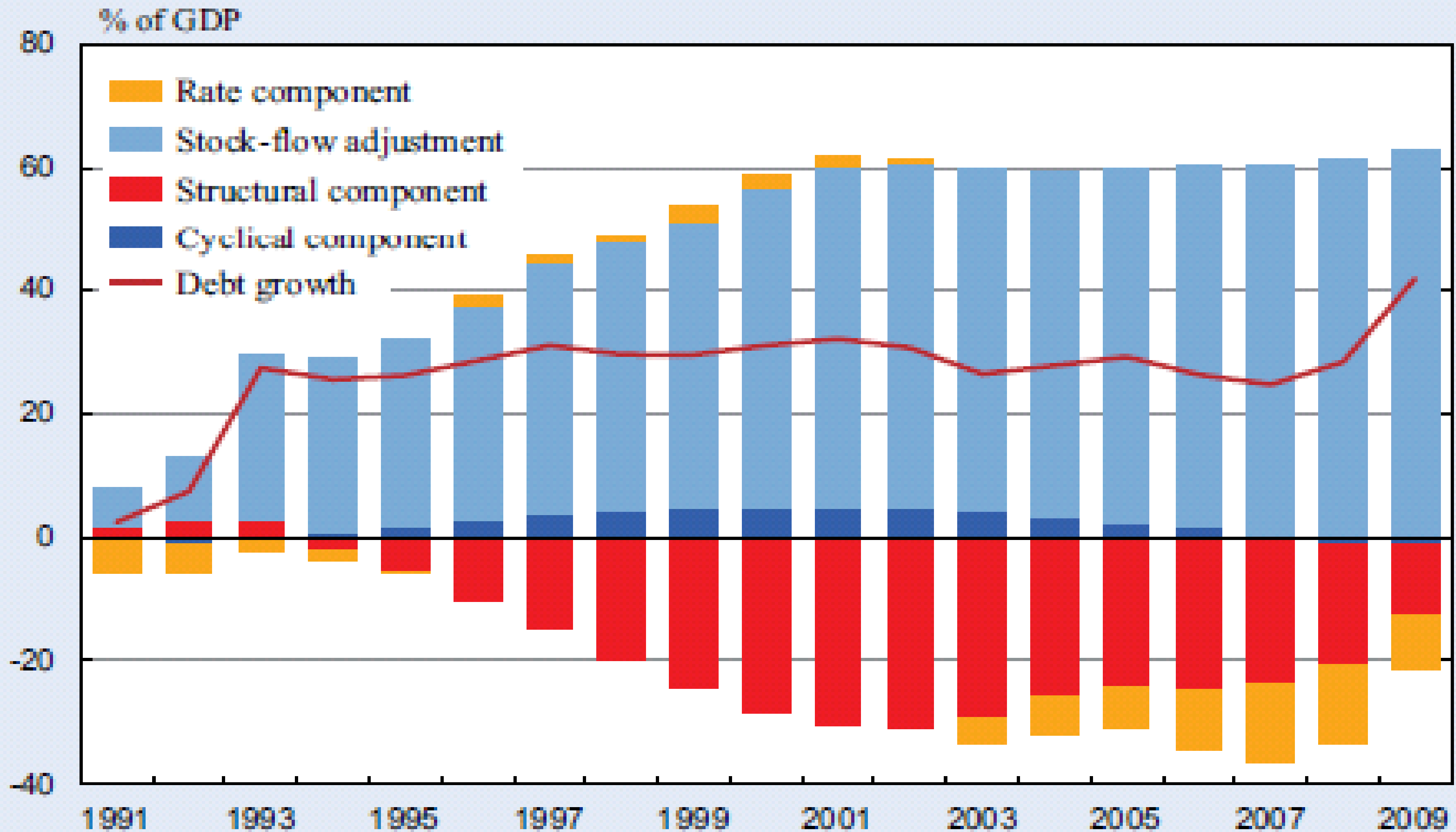


FIGURE 9

Who owns Greek Government Debt?

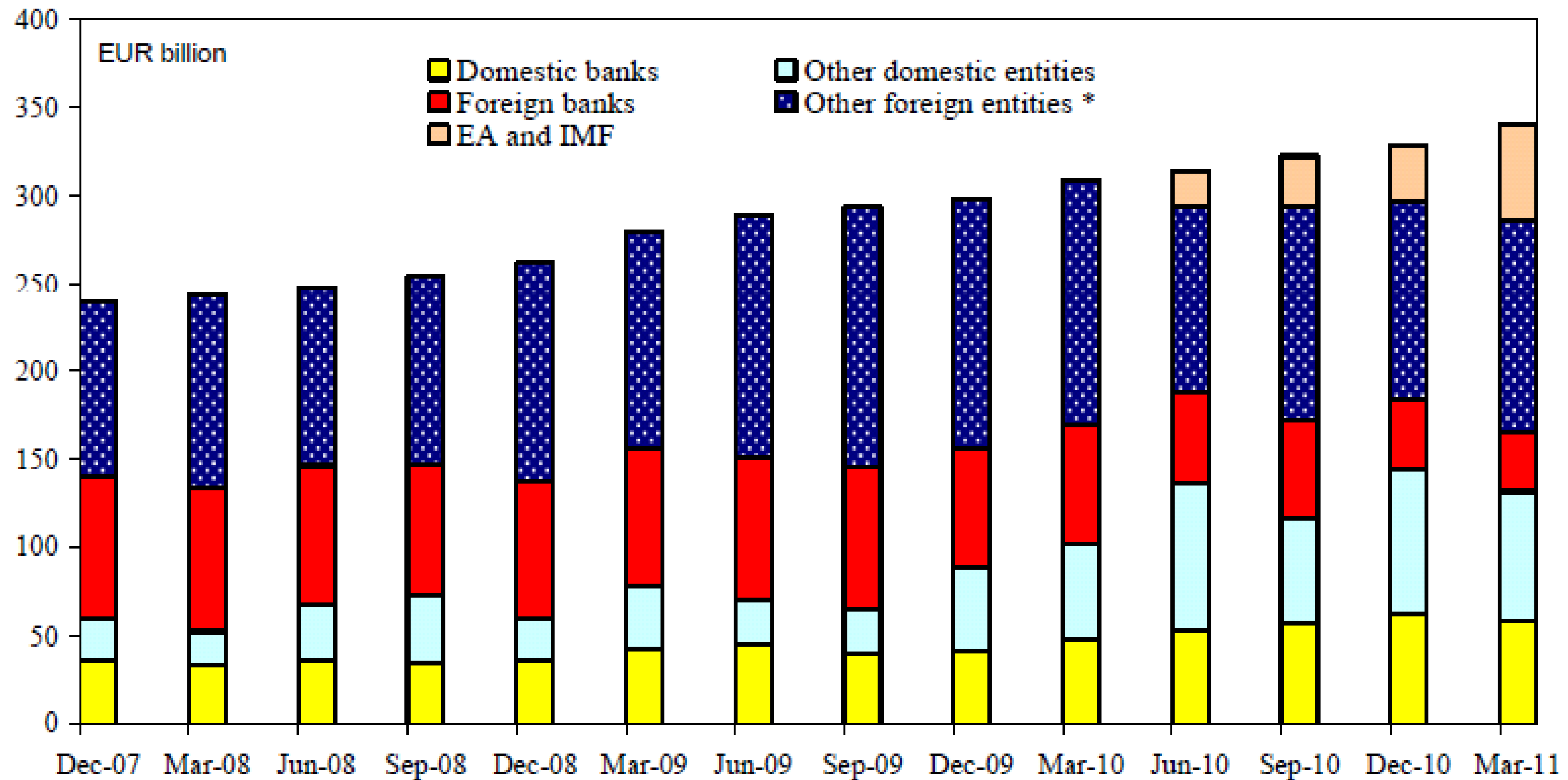
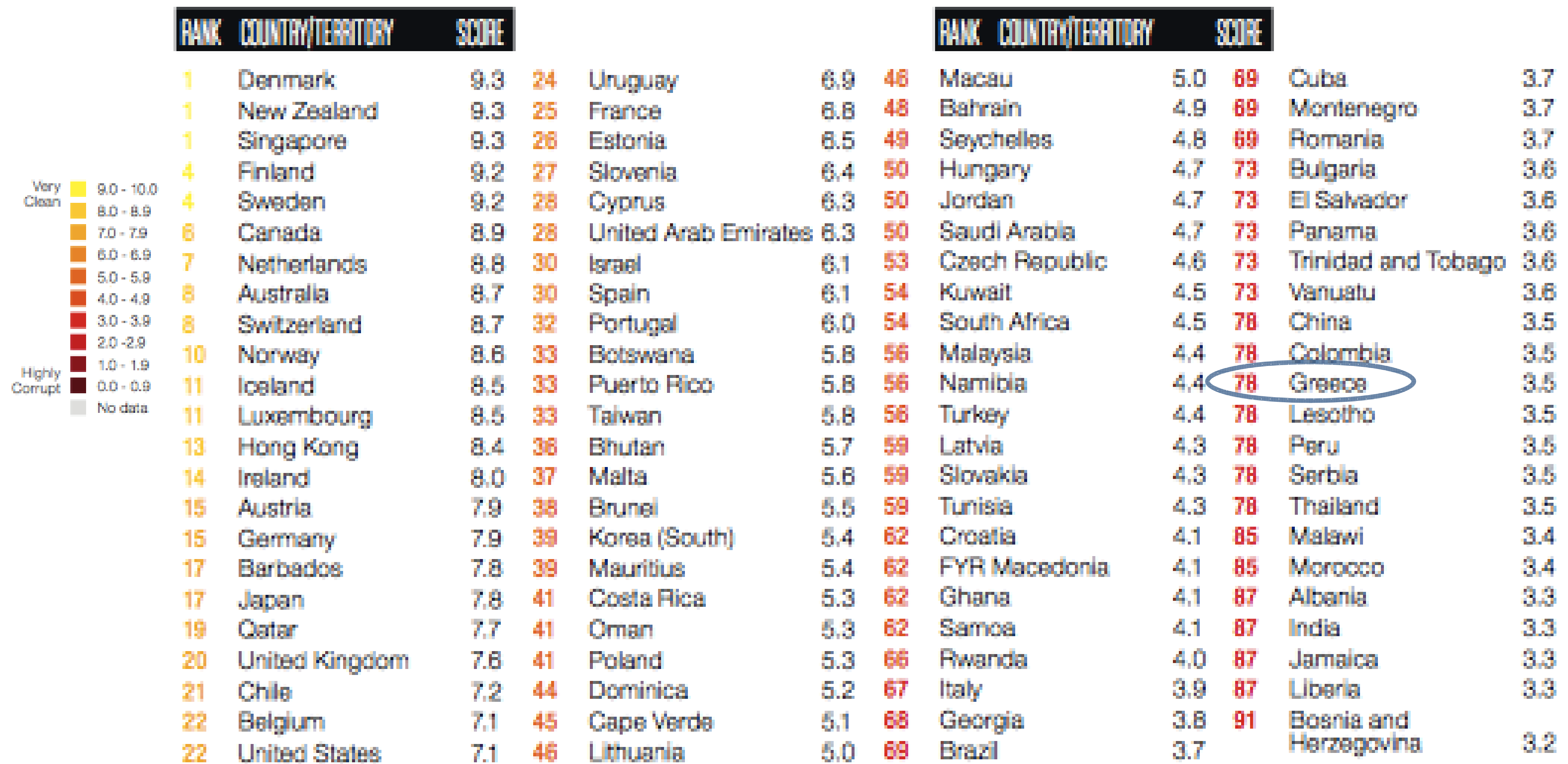


FIGURE 10

Corruption: The Picture in 2010 (178 countries)

Source: Transparency International Annual Report, 2010



RANK	COUNTRY/TERRITORY	SCORE
1	Denmark	9.3
1	New Zealand	9.3
1	Singapore	9.3
4	Finland	9.2
4	Sweden	9.2
6	Canada	8.9
7	Netherlands	8.8
8	Australia	8.7
8	Switzerland	8.7
10	Norway	8.6
11	Iceland	8.5
11	Luxembourg	8.5
13	Hong Kong	8.4
14	Ireland	8.0
15	Austria	7.9
15	Germany	7.9
17	Barbados	7.8
17	Japan	7.8
19	Qatar	7.7
20	United Kingdom	7.6
21	Chile	7.2
22	Belgium	7.1
22	United States	7.1
24	Uruguay	6.9
25	France	6.8
26	Estonia	6.5
27	Slovenia	6.4
28	Cyprus	6.3
28	United Arab Emirates	6.3
30	Israel	6.1
30	Spain	6.1
32	Portugal	6.0
33	Botswana	5.8
33	Puerto Rico	5.8
33	Taiwan	5.8
36	Bhutan	5.7
37	Malta	5.6
38	Brunei	5.5
39	Korea (South)	5.4
39	Mauritius	5.4
41	Costa Rica	5.3
41	Oman	5.3
41	Poland	5.3
44	Dominica	5.2
45	Cape Verde	5.1
46	Lithuania	5.0
46	Macau	5.0
48	Bahrain	4.9
49	Seychelles	4.8
50	Hungary	4.7
50	Jordan	4.7
50	Saudi Arabia	4.7
53	Czech Republic	4.6
54	Kuwait	4.5
54	South Africa	4.5
56	Malaysia	4.4
56	Namibia	4.4
56	Turkey	4.4
59	Latvia	4.3
59	Slovakia	4.3
59	Tunisia	4.3
62	Croatia	4.1
62	FYR Macedonia	4.1
62	Ghana	4.1
62	Samoa	4.1
66	Rwanda	4.0
67	Italy	3.9
68	Georgia	3.8
69	Brazil	3.7
69	Cuba	3.7
69	Montenegro	3.7
69	Romania	3.7
73	Bulgaria	3.6
73	El Salvador	3.6
73	Panama	3.6
73	Trinidad and Tobago	3.6
73	Vanuatu	3.6
78	China	3.5
78	Colombia	3.5
78	Greece	3.5
78	Lesotho	3.5
78	Peru	3.5
78	Serbia	3.5
78	Thailand	3.5
85	Malawi	3.4
85	Morocco	3.4
87	Albania	3.3
87	India	3.3
87	Jamaica	3.3
87	Liberia	3.3
91	Bosnia and Herzegovina	3.2

FIGURE 11