



The Greek and EU Crisis for non-economists

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Greece has three big economic problems



- Significant public sector deficits
 - Very inefficient public sector; corruption in procurement
 - Tax evasion; need new tax enforcement
- Huge accumulated debt it cannot fully service, partially alleviated by privately-held bonds haircuts
- Lack of competitiveness caused by
 - Union power that has increased wages and salaries without productivity increases
 - “Closed” sectors (“professions”), including taxis, trucks, pharmacies, engineers, lawyers, notaries, ...
 - Fixed exchange rate (locked in the Euro)



Greece also has big social problems

- Law and order breakdown
 - Hundreds of strikes (see www.apergia.gr)
 - Hundreds of demonstrations
 - Downtown Athens has been burned a number of times by hooded “those against state power” even before the economic crisis
 - Murders at Marfin Bank of workers who did not strike
 - Busts of Kazantzakis and El Greco were stolen right in front of the Academy (2 blocks from Syntagma) and were melted
 - 2 mil illegal immigrants in a country of 11 million (official census 11.3 mil in 2011)
- “Golden Dawn” attempts to take over the functions of the police and use violence
- Sharp increase of drug addiction, especially among the immigrants



Greek economy at a glance

- Gross Domestic Product (roughly total production) \$300 bil (2011)
 - Per capita income \$27,000 (29th richest in the world)
- Greeks are much more prosperous than these numbers show
 - **“Black” (informal) economy about 30-40% on top of formal**
 - Including it would make per capita income \$35,000-38000
 - Black economy does not pay taxes
- Main economic activities:
 - Services (including tourism) 85%
 - Industry/manufacturing 12%
 - Agriculture 3%
- Joined euro in 2001 at 340 drachmas to Euro
 - 15th largest economy among 27 in EU (without the black economy)
 - Largest economy than all rest of Balkans combined
 - Significant regional investor (Greek companies have invested extensively in the Balkans and Turkey)



Long term adversary: Turkey

- Greece spends more as a percentage of GDP on defense than any other NATO country except the US
- Buys weapons from US, Russia, China, France, Germany, UK, Israel, ...
- Very small domestic arms production
- Had a relatively large conscript army until recently

Greece is bankrupt since 2009

How did it get there?



- From 1982 to 2009 Greece borrowed \$300 billion, equal to its GDP in 2011
 - This is a debt of \$27,000 per capita
- This is on top of another \$300 billion of net transfers (gifts) to Greece from the EU
 - Greece received a whole year's income as a gift from the EU, and borrowed another whole year's income
- Even with all these moneys, Greece is bankrupt
- **The present generation of Greeks ate all its money as well as the money of its children and grandchildren!**



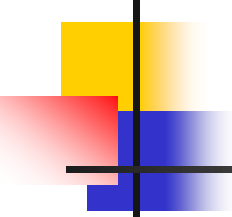
Causes of the Greek budget deficit and debt?

1. State spending; because of corruption and patronage

- Very excessive number of civil servants (800,000 in a country of 11 mil), salaries and pensions are 80% of the national budget
 - Could and should be reduced by 150,000
 - But no elected political party supports a serious reduction!
 - Demonstrations even when only a 2000 cut was proposed
- The state buys at very high prices (50-100% above competitive prices)
 - Very big scandals in defense dept. and hospital procurement

2. Inability of collect taxes

- Corruption of tax collectors
- Corruption of tax payers (at all levels of income)
- 4-4-2 system explained by Prof. Diomidis Spinellis; tax collectors
 - Forgive 40% of the tax fine for underpayment
 - Ask for 40% bribe to the fax collector (under the table)
 - State collects only 20% of the total tax obligation



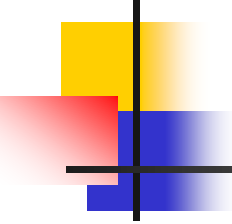
Dealing with the crisis: “Mnemonia” Memos of understanding between the creditors (EU, IMF, ECB) and Greece

- Mnemonio #1 (May 2010) (Papandreou – Papakonstantinou)
- \$145 bil (\$40 IMF, \$105 EU); interest 2.5%
 - Reduce budget deficit (partially successful)
 - Cut wages and pensions
 - Cut public investment (wrong target!)
 - Civil servant salaries were cut to lower levels rather than the much better option of reducing their number
 - Implement structural reforms in labor markets, opening closed “professions”
 - Total failure; not a single “profession” has been opened

“Private Sector Involvement” (PSI)

Greek Debt Not Held by the EU and IMF cut by 74% in March 2012: Debt Haircut





Mnemonio #2 (February 2012) (Papademos – Venizelos)

- Haircut on privately-held Greek debt
- Cut by 74% (approximately \$107 bil)
- Significant new loans to Greece and Greek banks were required because 1/3 of the bonds were held by Greek banks and pension funds that needed to be recapitalized
- Net cut of the debt about \$75 bil



Problem with pension funds because they had invested in Greek bonds

- Based on a 1954 law the “minister of economics makes the investment decisions for the shares of pension funds of state employees and state controlled companies” including the National Bank of Greece and DEH, publicly traded companies
- So, the various ministers and their puppets at the pension funds voted to buy Greek bonds (and, even worse, to hold on to them in 2010, after the crisis was public), even though they could sell at only 10% loss
- Pension funds realized losses of over 50% and now have difficulties paying pensions without government help.



Mnemonio #3 (December 2012) (Samaras - Stournaras)

- Banks received 50 bil for recapitalization
- Greece received continuation loans
- Greece promised to implement structural reforms (again)
 - For every installment of the loans there is renegotiation because usually Greece does not achieve the targets



Present economic condition

- Unemployment over 25%
- Youth unemployment 58%
- 5 years of recession
- Income down 20-25% (from 2008)
- Real income (adjusted for inflation) down 30% (from 2008)
 - Pensioners, unemployed, and the poor suffering
- **Primary surplus (revenue minus expenditures, ignoring taxes) at end of 2013**



OPTIONS FOR GREECE



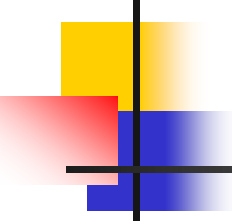
Three options available (October, 2013)

- A. Implementation of structural reforms, staying in Euro, create a special fund for investment
- B. Rejection of lenders' terms, hard default, adoption of a new drachma (rejected by voters 7/12)
- C. To make no significant changes, linger in the present swamp, leading to eventual bankruptcy ("death by thousand cuts")

**In my opinion, "A" is by far the best
How should it be done?**



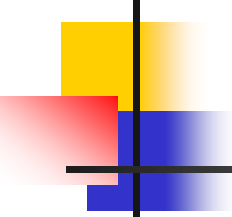
Option A: Implement structural changes, stay in Euro



Option A: What needs to be done inside Greece (1)

Take immediate radical measures:

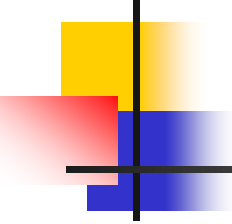
- Reduce the public sector
 - Cut the general (non-wage) expenses of the state; change procurement processes
 - Reduce the number of civil servants over and above the natural attrition of 5% by
 - (i) closing useless divisions
 - (ii) eliminating jobs that have been surpassed by technological change
 - (iii) evaluating performance in the remainder of the civil service



Option A: What needs to be done inside Greece (2)

Take immediate radical measures:

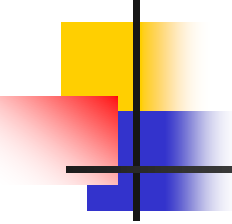
- Do not impose new taxes
- Collect the existing taxes
- Reduce (presently rampant) tax evasion
- Do it by creating a new tax police and tax courts that work fast
 - Similar to the creation of the FBI to deal with rampant lawlessness in the Midwest in the 1920s, because of corruption in Illinois and other States



Option A: What needs to be done inside Greece (3)

Immediate necessary measures

- New investments in infrastructure
 - From EU structural funds
 - By saving money from civil servants wages and investing businesses that create jobs



Option A: What needs to be done inside Greece (4)

Implement the many other structural changes that will have effects over time

- Liberalize the labor market
- Open the “closed” professions
- Other structural reforms



Option A: What needs to be done externally (by EU, IMF, & ECB)

- **Create a grace period of 3-5 years on interest of loans to the official sector (EU countries)**
 - without an increase of the size of the loans
- **Use the resulting €5-6 billion per year only for investment, creating jobs and tax revenue**
 - Greek gov. does not use for pensions and other budget obligations



Option A: What needs to be done externally (by EU, IMF, & ECB)

- Extend the fiscal consolidation period and reduce its year-by-year intensity
- Receive the EU structural investments for infrastructure and possibly renewable energy



Option B:

- Reject lenders' terms, and declare bankruptcy (hard, uncontrolled default), leading to the drachma and "sudden death" (rejected by voters in recent election, 7/12)
- Three political parties in the parliament (SYRIZA, Independent Greeks, and Golden Dawn) have positions close to option B



Greece leaving the euro is very bad for debt

- If Greece leaves the euro, its “new drachma” will be devalued significantly compared to the old drachma
 - Old drachma to euro approx. $340 \text{ dr} = 1 \text{ €}$
 - New drachma to euro approx. $1000 \text{ Ndr} = 1 \text{ €}$
- Debt is in euros, suddenly gets multiplied by 3 in new drachmas
- Outside the euro, Greece will be forced to borrow at very high interest rates
- Debt will be unsustainable (again)
- It will be very hard to reduce the debt because most of it will be to EU countries and the IMF



Greece leaving the euro will create very high inflation

- Will result in very high inflation in Greece where practically everything is imported
 - Prices in Greece will be multiplied by 3, wages and pensions cannot adjust quickly, and Greeks will become much poorer
- To pay public servants salaries and pensions, Greece will print too many new drachmas, thereby creating an inflationary spiral
- Greek politicians (who have already proved to be irresponsible) will have an “easy way out” by printing drachmas
- Will create hyperinflation



Greece leaving the euro will lead to bank collapse

- If leaving the euro is anticipated, Greek banks will collapse because
 - Depositors will withdraw their euros (what little is left in banks) because they will not trust the government to convert them to new drachmas at the “right” exchange rate
 - The ECB will withdraw its lifeline of more than € 128 billion cash to Greek banks



In summary, Greece leaving the euro will result in

- Greek banks collapsing even before the new drachma is introduced
- Extreme poverty as goods become three times more expensive
- Hyperinflation as Greek politicians will now be able to print currency
- Likely social unrest
- **Greece has significant national and political reasons besides economic reasons to stay in the Eurozone at the core of the EU**
 - Danger of isolation in a neighborhood of a very aggressive enemy which can easily overpower Greece militarily
 - Greece needs the support of the EU and the US to counterbalance



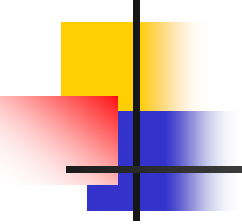
Option C:

Make no significant changes, linger in the present swamp, leading to eventual bankruptcy ... (“death by thousand cuts”)



Option C: The biggest danger

- The Greek government has to act decisively now!
- Biggest danger is inertia, not acting on:
 - Cutting the expenses of the state sector
 - Implementing structural reforms
 - Reducing tax evasion



Is there hope for Greece?

Yes!

- But things have been on a knife-edge for 3 years now
- People and businesses are tired of the uncertainty
 - Desperately need “good news”
- People are close to exhausting their savings as new taxes have been imposed when salaries were falling
- Nevertheless I am optimistic



What should be done now?

- Get a grace period of 3-5 years on interest of EU loans
- Use the resulting €5-6 billion per year only for investment, creating jobs and tax revenue
 - Greek gov. does not use these moneys for pensions and other budget obligations
- Make the recovery happen in 2014!

