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
    - Last month the busts of Kazantzakis and El Greco were stolen right in front of the Academy 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
- 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!
Debt as a percentage of GDP

Greek debt in comparison to Eurozone average

Debt percentage

Source: Eurostat
*estimates
Where did/does the money go?

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
Greece has not dealt well with corruption over time: Two cases


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 reducing their number (big mistake)
  - Implement structural reforms in labor markets, opening “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
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 typically Greece does not achieve the targets
Present economic condition

- Unemployment over 25%
- Youth unemployment 58%
- 5 years of recession
- Income down 20% (from 2008)
  - Pensioners, unemployed, and the poor suffering
- Some tax increases backfired resulting in higher tax evasion than earlier
OPTIONS FOR GREECE
Three options available (March, 2013)

A. Implementation of structural reforms, staying in Euro
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 (with 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
- Get a grace period of 3-5 years on interest of loans to the official sector (Economides-Pissarides proposal at WSJ, June 2012)
  - Without an increase of the size of the loans
  - Use the resulting €5-6 billion for investment
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 a 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
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
Cyprus has a large financial system compared to the rest of its economy

- Ratio of banking assets to GDP in Cyprus larger than Malta but much smaller than Luxemburg
- Allegations of money laundering by Russians

Causes of the Cypriot bank crisis

- Haircut on Greek bonds held by Cypriot banks
- Non-performing loans in Greece and Cyprus
Cyprus needed at least €15.5 bil support; EU gave only €10

3/15/13 deal imposed on all banks:
- 7.5% haircut on deposits below €100,000
- 9.9% haircut on deposits above €100,000

Rejected by Cypriot parliament

New deal
- ESM/EFSF funds were not used, even though these funds were created for that purpose!
- Cypriot banks sold subsidiaries in Greece to Piraeus Bank
- No haircut on deposits below €100,000
- Close Laiki Bank with losses of 80% on deposits over €100,000
- Restructure Kyprou Bank with losses of 40% on deposits over €100,000

Cyprus will decline as a financial center
EU officials now say that deposits in Europe not untouchable

- Rehn (EU's economics commissioner): “If a bank fails, depositors with over €100,000 can take a hit,” 4/6/13, Reuters & Finnish TV
- In contrast, in the US, FDIC insures deposits to $250,000 and the Fed has not imposed a haircut on any large depositors of failing banks for the last 50 years
- The (new) position of the EU on banking will lead to a bank run out of Southern European banks towards Germany, UK, and US
- This is a disastrous position for the EU taken only to support Merkel’s coalition in upcoming elections
EU does not have stable rules

- Each bailed-out country (Greece, Portugal, Ireland, Cyprus) has faced different rules – Cyprus was treated worst, then Portugal, Greece, Ireland
- Clear-cut ways to separate banking problems from sovereign problems though the establishment of the Emergency Funds (ESM/EFSF) were first adopted and later abandoned
- Banks were forced to buy sovereign debts and were then rescued by the states
- The debt accumulated by the 2008 crisis lingers
- Most of the EU is in recession