Commencement Time for Greece

1. Greece: From boom to bust

The recent Greek debt crisis came as a surprise. Greece for 13 consecutive years - from 1996 to 2008 - went through a growth miracle, with an average rate of economic growth of approximately 4%, 2 percentage points above the old EU-15 average. The Greek relative standard of living gradually improved from 72.4% of the EU-15 average in 1996 to 87.4% in 2009. Yet, this boom reached a sudden stop and today Greeks face a trajectory of divergence rather than continuous convergence to the EU-15.

The past rapid growth was no accident. Its roots can be traced to the determined efforts of the Simitis center-left governments to ensure Greece would satisfy the Maastricht criteria and become a member of the Euro Area. Thus, in the second half of the 1990s, Greece managed to bring down its double digit rate of inflation to the range of 2%-3% and control its rising public debt-to-GDP ratio. The subsequent decline in market interest rates and the renewed business confidence and euphoria about the new stable EMU regime brought a huge expansion in private investment spending, increased household borrowing, expanded domestic consumption and led to continuous growth. As a member of the Euro Area, Greece enjoyed relative macroeconomic stability with low inflation, a stable currency and a fiscal policy constrained by the Stability & Growth Pact.

Joining the Euro Area was not a panacea, however. It opened the country up to new challenges. Greece had to be able to compete internationally without the macroeconomic tools of interest rates and exchange rates. It had to create an efficient, flexible and transparent economy, eradicate public waste, minimize bureaucracy, grab the rampant tax evasion, rationalize its pension system and open up its product markets to competition, away from the oligopolistic practices of a few interest groups. Yet, structural reforms which interfered with interest groups or the life style of the population proved hard to carry through and required strong presence in the Greek parliament by the political party in power. For example, when the Simitis government tried to rationalize the pension system in 2001, labor unions objected – to what by today's standards was a minor reform - and brought one million people, or 1/10th of the population, in demonstrations around Athens. Given its thin majority in Parliament, the government backed away. The government also wasted valuable time, effort and resources trying to prepare for the subsequent successful 2004 Olympic Games.

A new center-right Karamanlis government won a landslide victory in March 2004 on the agenda of reforms, but puzzlingly, failed to accomplish its pre-electron reform agenda. The Greek inflation was running consistently above the Euro Area average inflation and real wages expanded faster than productivity, leading to a deterioration in competitiveness. The country's global competitiveness rankings sank deeper than before and there was an

abrupt deterioration in the current account deficit, which shot up from 6.5% of GDP in 2003 to 14.4% in 2007. In the beginning, the government did manage to keep the fiscal finances under relative control since the debt to GDP ratio did not deteriorate. Yet, in September 2007, the center-right governmental majority in Parliament thinned out and the government went on a spending spree, abandoning fiscal prudence. In 2008 & 2009, Greece had the largest or second largest fiscal deficits in EU27, although growth continued into 2008 and its 2009 recession was half the size of the recession in the Euro Area. Public expenditure jumped by 5 percentage points above the average of the previous 25 years. Not even during the years leading to the 2004 Olympic Games was public expenditure that high!

The collapse in fiscal discipline became apparent in the last quarter of 2009. Markets became nervous that a shrinking economy could not easily generate the tax revenues required to pay the promised interest and capital to Greek Government Bond (GGB) holders. The debt – to-GDP ratio, which for a decade was kept at around 100%, was now in an explosive upward path. Financial markets drove interest rates on GGBs way above the equivalent German Bunds, and eventually refused to lend Greece more money. Greece was trapped. Then in May 2010, EMU members, after months of agonizing and wavering, came to the rescue together with the IMF with a €110bn loan - €80 bn from EMU plus €30bn from the IMF - over a three year period, which was accompanied by strict conditions on the sequence and timing of reforms and a time table for the stabilization of the economy. The loan did not come cheap. The EMU interest rate on its loans to Greece is at least 3% above the borrowing rates of the contributing members. This is a profitable - great arbitrage - opportunity for EMU contributing members if the Greek stabilization program eventually succeeds.

2. Are markets correct to expect program failure and possible default?

Currently, thanks to the EMU/IMF assistance loan, Greece does not need to borrow from the open market for about 2.5 years. It has gained a time window to fix its public sector problems and bring its economy back to health. Yet, market interest rates on 2-year GGBs have risen since May and are now above 10%. This is a very puzzling and disappointing development. Apparently, markets strongly doubt the ability of the Greek government to carry the reforms and satisfy the conditions of the Memorandum of Understanding with the EMU and the IMF in order to access the promised money on a continuous basis. They may also doubt the ability of EMU members to provide the loans.

The Credit Default Swap rates also suggest that markets attach a very high probability to the event of a major haircut in Greek debt obligations. The argument that floats around the London investment banks and hedge funds is that even if the EMU/IMF program succeeds and the reforms are carried as planned in the MoU, problems would still arise for holders of Greek debt. This is because by year 2012 or 2013 the Greek State would regain the ability to collect revenues of sufficient size to pay all its domestic expenses except for

the interest on its debt. Then it would be tempted to declare it can no longer accommodate its past debt obligations and default partially of fully. Many academics and opinion leaders have also argued in major international financial newspapers that default is the rational – or inevitable - choice for Greece, since a debt to GDP ratio of 150% is too much sustain and can easily be reduced to, say, the Maastricht target of 60%, by unilaterally enforcing a 60% haircut. Such a move would presumably free up fiscal resources to be employed productively elsewhere and promote domestic growth.

I find this view on voluntary default inconsistent with the economic and political realities in Greece and the Euro Area. The stakeholders of GGBs are primarily Greeks and other EMU members, who have a strong incentive against the default solution. Greek banks own approximately €45 bn, pension and other funds another €25bn, individuals around €15bn. EMU banks also hold a major chunk of GGBs. The ECB holds significant amounts of GGBs and Greek Government guaranteed bonds as collateral for liquidity loans it has given to Greek banks. A haircut would put all these stakeholders at a disadvantage, thus it would not be allowed to occur. It makes no sense for the Greek government to have to bail out its own banking and pension system or to go against its EMU lenders and the ECB, its own central bank. Haircuts would shut the country out from the core of Europe and from financial markets for a long time. Financial and political costs are huge and overwhelm the savings in interest expenses, which max out at 4% of GDP under the haircuts mentioned earlier. It also makes no sense for other EMU members to allow a Greek default even by penalizing Greece with a forced exit from the Euro-Area and the EU, since such an extreme action would carry huge costs on many European countries' banking systems, the operations of the ECB and, more importantly, would risk a contagion to other countries and set the stage for the unraveling of the Euro Area.

In my view, default would occur not by choice but by necessity. This necessity would arise only in the extreme scenario that the Euro Area dissolves. If this were to happen, the negative consequences would be European wide, not only Greek. Greece would clearly suffer a severe recession and subsequently follow the well advertized Argentine example. Yet, I do not share the widely held view across the Atlantic that the Euro Area is about to come apart. The current international sovereign debt crisis may have exposed the lack of a solid fiscal mechanism within the Euro Area, but European politicians are responding to the pressing demands of financial markets. They have already established a mechanism to deal with crises and soon will decide on a mechanism to avoid crises. Later on, they will have to come to grips with intra-EMU imbalances and ways to minimize them.

I also view the probability that the program fails or muddles through while EMU stays intact as being very low. If the program muddles through, having only partial success, all that would happen is a prolonged period of economic stagnation and stricter future supervision by the EMU/IMF. It would not lead to extreme actions like expulsion from the Euro Area and the EU.

The EMU/IMF baseline scenario assumes a low rate of inflation and a big recession in 2010 and 2011, which takes into account the negative repercussions of fiscal tightening on the economy. Then, in 2012, it foresees a slow recovery, which eventually leads to a rate of economic growth of 2.7% per annum, a magnitude which is considerably smaller than the average growth of 4% of the pre-crisis years. With those magnitudes, the EMU/IMF predicts the ratio of debt-to-GDP to rise to 149% by year 2013 and then to decline steadily towards 119% in 2020. Using the EMU/IMF profile for future deficits and GDP growth, it is easy to calculate that the distance to default becomes bigger and bigger as time goes on.

My own analysis shows that if inflation were 0.85% higher per annum, which is more reasonable given the recent VAT increases and the previous history of Greek inflation, the debt-to-GDP ratio can reach 90% in year 2020, 30 percentage points lower! And if output were 0.5% higher than the baseline assumption, still remaining below the previous historical standard, then the debt – to – GDP ratio can decline to 72% in year 2020. Hence, besides fiscal consolidation, the other critical variable for the future stability of public finances in Greece is the rate of expansion of nominal economic activity.

Next, I address the two major concerns in Greece today. First, can fiscal consolidation take place in practice? Second, when would growth come back and how?

3. Fiscal consolidation is likely

It will not be easy to get the fiscal mess under control. Neither will it be easy to regain credibility among the European partners and the financial markets. Yet, we should not overlook the remarkable transformation taking place in Greece today. When Prime Minister George Papandreou addressed the nation right after the February Economic Policy Forum meetings in Davos and talked about a wage freeze and a rise in gasoline taxes, 2 out of 3 Greeks reacted positively! This is a higher percentage than the people who voted for him back in October 2009. This support for austerity and control of public finances continues to the present, even after most Greeks already felt the decline in their disposable incomes, as their Easter bonus was reduced or cut. Apparently, the average Greek understands very well the deep hole the country is in and is genuinely thirsty for a good manager-politician to put order in public life. People seem to be fed up of years of waste, tax evasion, public sector inefficiencies and an economic system that does not always reward hard work and law abiding behavior. This is why the demonstrations to the current proposals for a drastic pension reform only drew one twentieth the size of demonstrators relative to the 2001 incident.

The expected fiscal consolidation is drastic and the program leaves room for slippage in expected revenues or expenditures. Total measures up to year 2014 amount to ca €42.5bn or 17.8% of 2009 GDP. These measures contain a big cushion as the expected reduction in the fiscal deficit is a lot less, namely 10-11 percentage points of GDP, from 13.6% in 2009 to less than 3%

in 2014. During the current year, the fiscal deficit is supposed to decline by 5.5 percentage points of GDP, but the measures are worth 7.7 percentage points, leaving a cushion of 2.2 percentage points in case the recession turns out bigger than anticipated or the government fails to generate the revenues it has budgeted.

So far the government is within its new annual budget targets. On the expenditure side the task is easier. It is straightforward to legislate reductions in expenditures and carry them on. And the government has done it. It has cut the 13th and 14th salaries of public employees and pensioners as well as many other pecuniary incomes. The 2010 nominal wage and pension bill in the new central government budget is 15% less in 2009! Of course, it is much harder to increase revenues as taxes are harder to collect. Yet the second leg of the VAT increase kicked in on July 1st and one has to wait till September to see how the tax collection is panning out.

A hidden cushion in the EMU/IMF program is also the future effects of the new tax law. In Greece, personal income taxes bring revenues equal to 8% of GDP, whereas in the EMU around 12%. The gap of 4 percentage points is due to the underreporting of the income of the self employed, who represent 36% of the labor force in Greece but only 15% in the Euro Area. These guys only contribute 4% of the personal income tax! Starting in 2011, the life style of the self employed will determine a minimum imputed income and thus a minimum tax, no matter what they claim. This life style (size of house, existence of vacation home, number and type of cars, kids in private schools, swimming pool, house help, etc.) is known to the tax authorities and is computerized. So a doctor may claim she earns 20 thousand euros, but her life style may show an imputed income of 100 thousand. This would make a huge difference in the collection of personal income tax. Citizens will have the right to appeal the imputed income, but then they will be audited.

Another cushion is the underreporting of the VAT by businesses, which is likely to decline. There is a €12k personal income tax exemption in Greece but from this year on in order to qualify for it, citizens would have to submit receipts for goods or services of approximately half that amount. The measure was widely advertised in the local media well ahead of its introduction, reportedly stimulating a big drive by Greek consumers to collect retail receipts, thus forcing enterprises to reveal more of their true revenues and stop cheating on the VAT.

On the expenditure side, there is enormous room for cost reductions without affecting the services provided by the public sector. A major source of waste is the National Health System, the local governments and wider pubic sector enterprises. Many concrete steps are taken to address the problem, including outsourcing to international auditing firms the auditing of large hospitals and enterprises, minimizing the number of prefectures at the local government level, or instituting a tighter control of budgets through the Single Payment Authority at the Ministry of Finance.

4. Radical and painful structural reforms

The structural reforms included in the EMU/IMF program are drastic, particularly the pension & labor reforms, which are front-loaded in order to avoid a possible reform fatigue by the population. The pension reform already went through Parliament and will save 10 percentage points of GDP per annum in State pension expenditures in the next 50 years! The new pension law puts Greece right at the EMU average in terms of the future increase in state pension liabilities, which can rise by up to 2.5% of GDP until year 2060. No more loopholes in the retirement age of 65, a floor which is going to be adjusted upward in the future according to life expectancy. No more early retirement before the age of 60 and at a bigger penalty than before. The size of pensions will now be made a function of life time contributions and the minimum contributory period for retirement is going up to 40 years from 37.

Labor reforms are under discussion and are also drastic, aiming at increasing flexibility in the labor market. Central bargaining will be abolished and provisions are included for local contracts in areas of high unemployment which give the ability to set wages at levels below the minimum. The minimum threshold for activating rules on collective dismissals will be raised especially for larger companies from the current 2% to 4%. The use of temporary contracts and part-time work will be facilitated. Variable pay is introduced in order to link wages to productivity performance at the firm level. The wage of new entrants in the labor force is expected to be reduced from €740/month by ca 20% to €590/month and minimum nominal wages will likely freeze for the next 3 years.

Product market reforms, which will tackle special interest groups like truck drivers, notary public officials, lawyers, pharmacists, etc. are being discussed and will soon be installed. They are expected to unleash product and service market competition, improve efficiency and GDP growth by a substantial margin. Privatizations are also on the agenda, but for the moment the plan is not very aggressive. I expect them to gain priority in the Fall, once the labor reform clears through parliament and policies to promote growth will dominate the political agenda.

5. Growth dynamics

Strict fiscal austerity and radical reforms can fix the long-term health of the economy but cannot pull it out of the recession. What will pull it out is a return of business and consumer confidence, a reversal in the decline of private and public investment and an expansion of the net exports sector. Investment expenditure can reverse its decline only if the government manages to improve its absorption rate of the available EU funds and thinks of smart ways to attract private capital through privatizations, long-term leases of property, Build-Operate-Transfer deals or other Private - Public – Partnerships. The EMU/IMF program sets binding targets for payment claims of Structural and Cohesion Funds: By 2013, Greece has to absorb €13.7bn or 5.5% of its GDP. Also, in order to promote investments and exports and in

line with EU competition rules, the Government has to take measures to facilitate FDI and investment in innovation in strategic sectors (green industries, ICT etc.). A revision of the Investment Law, fast-tracking large FDI projects and measures to strengthen export promotion policy are in the pipeline.

The net exports sector is already contributing positively to growth as exports are expanding – thanks also the euro depreciation. World exports are likely to increase by 10-15% over the period 2010-11, leading to a similar increase in Greek exports of goods, which historically follow the expansion in world demand, without even counting the recent improvement in competitiveness that come form the wage reductions. Also, 57% of Greeks exports go outside the Euro Area, so the current fiscal tightening in Europe which is bound to reduce European growth will not have a large negative impact. Greek imports are also declining fast and thus contribute positively to growth. In 2009, they declined by 15%, a process which is expected to continue as long as disposable incomes shrink. Indeed, in 2010, real disposable incomes are expected to drop by 10% and private consumption by a whopping 6% or more, yet the effects on domestic value added will be smaller. Households respond to a drop in current income by postponing the purchase of durable goods like cars, expensive furniture and big ticket electronic items, most of which are imported.

We expect that 2012 will be the first year that the Greek economy will register positive growth. Subsequent growth will be driven mainly by gains in productivity and competitiveness. Average annual productivity growth in 2000-2009 was 2.4%, or three times larger than the corresponding growth in Germany, Spain or Portugal. In the past, productivity benefited from investment in Machinery and Equipment. There are strong reasons to believe that high productivity growth will continue in the future, once the recession is over. First, the capital intensity of the Greek economy continues to remain below the EA average, indicating there is scope for further expansion of investment. Second, product market reforms are expected to free the economy from many bottlenecks and costs and bring vast improvements in efficiency and productivity, which some estimate to cumulate to as high as 15% of GDP. Third, public sector crowding in will also improve the economy's performance, as a smaller public sector leaves room for the more efficient private sector to expand. Fourth, the process of restoring competitiveness losses, through an internal devaluation, is not as onerous as often thought. A significant real wage decline is underway, as public sector wage cuts herald similar declines in the private sector. If one adds to this picture the devaluation of the Euro by ca 15%, which is reasonable to persist in the medium term and which favors exports outside the Euro Area, a considerable improvement of price competitiveness is likely to occur over the next two years. Last but not least, capturing the underground economy apart from the obvious benefits to revenue generation, it will also improve the much attended official debt-to-GDP ratio.

6. Conclusion

The Greek crisis is not the beginning of the end, but represents a new beginning. It pushes the nation to finally come to grips with its neglected structural problems and solve them in a short period of time and by building consensus. Greece has the ability to be successful because it is a country with a strong and unlevered private sector and is populated by a majority a hard working individuals who like to excel. Nevertheless, it also happens to be a country with an inefficient, disorganized and wasteful public sector, whose arbitrary and sluggish behavior over time has created a culture of corruption and disobedience. Today, Greek society has matured to realize those inadequacies and is thirsty for a new beginning. And the country is lucky in its misfortune, since the crisis occurred right after general elections, so that the new government has the political power to implement the required reforms plus it has the space of time in office, which allows it to be present in the future to begin reaping the rewards of that effort.