

91

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“Greece’s Economy: Crisis and Exit Strategies”

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It is a particular pleasure to be back at the LSE, see old friends and colleagues, and have the opportunity to address critical issues, such as the fate of the eurozone and Greece's place in it. I would like to thank, once again, Kevin and Maurice for organizing these events, and also for creating the framework, within this remarkable institution, for engaging a wider audience in discussing these issues.

Greece's crisis is intertwined with the eurozone crisis so that exit strategies can only be considered in the wider context. Looking back at the origins of the eurozone debt crisis it can be argued that the large external imbalances that were allowed to emerge over the last decade between the core and the periphery account for much of the problem encountered today. The competitive position of peripheral countries, particularly Greece, Spain, Portugal, Ireland and Italy, deteriorated sharply vis-à-vis the core countries of the eurozone. Lax fiscal policies and failure to promote productivity-enhancing reforms contrasted with the more disciplined and ambitious policies pursued in most core economies, particularly Germany. The persistence of these imbalances has transferred excess savings from the surplus core economies to the periphery creating the conditions for over-borrowing.

In fiscally responsible countries like Spain, excess savings resources have been borrowed by the private sector and invested in what later became bubbles-housing assets. Bad debts were eventually assumed by the government leading to an explosion of budget deficits and full-blown fiscal crises. In fiscally profligate countries like Greece, excess savings resources have mainly been borrowed by the government leading directly to a fiscal crisis.

Two years after the eruption of the crisis in Greece, a country accounting for no more than two percent of the eurozone's GDP, it is remarkable that the area's leaders have not found a way to confront it, still less to limit the contagion to other members of the currency union. The explanation partly lies in the fact that the euro is a unique experiment requiring special treatment. However, the politics of implementing the right remedies has proven to be exceptionally

complicated. The challenges facing the eurozone in its effort to overcome the crisis and restore conditions for stability and growth are threefold:

Solidarity, by providing finance for excessive deficits and sovereign debt repayments wherever they arise.

Discipline, by establishing rules and procedures for preventing – or discouraging – the emergence of fiscal imbalances.

Stability, by reinforcing competitiveness and promoting macroeconomic policies to curb excessive external deficits/surpluses which constitute the root cause of domestic financial imbalances, public or private.

Reconstructing the governance of the monetary union along these lines – solidarity, discipline, stability – implies a qualitative leap towards economic and political integration.

Fiscal federalism already exists in Europe in indirect forms, including the borrowing capacity of the European Commission (EC) and the European Investment Bank (EIB) as well as the collateral policy of the European Central Bank (ECB). A further step was taken with the creation of a bail-out fund, the EFSF. These tools have clearly been inadequate for dealing with the crisis. Issuing Eurobonds is widely acknowledged to be necessary for ensuring the functioning of the European bond market and prevent disruptive flights from peripheral to risk-free assets. A substantial expansion of the capital base of the EFSF is critical for enabling it to perform effective interventions and convince markets that the union possesses sufficient firepower to contain the spread of financial panic.

A European Finance Ministry should be part of the new governance structure. It should exert ongoing surveillance of both fiscal and competitiveness policies, intervene directly in the design and implementation of economic policies in failing countries and also assume responsibilities in financial sector policy and external representation. In particular, so far as the competitiveness and the

external accounts are concerned, the Finance Ministry should be empowered to determine the overall direction of fiscal policy so as to adjust the levels of economic activity across the eurozone and help redress destabilizing imbalances. Surplus economies should sustain higher levels of activity than deficit ones. Moreover, the Ministry should monitor competitiveness indicators and push for appropriate policies with regard to labour costs and productivity-enhancing reforms. Surveillance regimes should be established to this effect.

Equally, a substantial dose of banking federalism is required so as to help create a genuine European financial system, as opposed to a collection of national ones, as an indispensable complement to monetary unification. Responsibility for regulatory, supervisory, resolution, deposit guarantee and competition policies in the financial sector should be assumed by centralized authorities, including the recently created European Banking Authority.

Underpinning these changes in the structure of economic governance should lie a substantial upgrading of European institutions enabling them to support the federal frameworks for fiscal and banking policy in a politically sustainable manner. It is crucially important to supply democratic legitimacy for the executive decisions to be taken in these policy areas at the European level rather than the national ones. Reinforcing the European Parliament through an expansion of its oversight powers over the executive and budget functions of EU institutions and moving to a direct election of the EC President are steps in this direction.

The distance between the decisions taken in successive meetings of the European Council concerning the reform of the governance structure of the eurozone, and the framework suggested above is very wide. Sticking to half-measures has exacerbated markets' impatience and provoked increasingly determined speculative attacks, not only on the weaker peripheral countries, but also on core AAA-rated countries - like France - whose banking sectors hold large volumes of peripheral countries' debt.

The German-French agreement to involve the private sector in addressing debt problems, reconfirmed with the European Council decision on October 26 for a 50% "haircut" of Greek debt, further destabilized the markets. Instead of being taken as an exceptional measure as it was supposedly intended, it was interpreted as a precedent, leading to extensive dumping of peripheral countries' bonds.

The euro now faces a systemic risk raising doubts about its sustainability. In the context of weakened confidence, markets tend to overlook progress in fiscal consolidation or an improved outlook for reforms. Rising bond yields are being driven by a self-fulfilling panic. The emerging negative feedback loop could easily drive up the cost of bank and government funding, leading to lower economic growth, while raising the risk of defaults, particularly if investors shun peripheral countries' bonds on grounds that they are not risk-free assets.

The imminent threat to the eurozone calls for radical action. An eventual break-up of the union would entail huge economic and social costs arising mainly from uncontrolled financial disruption. Applying overwhelming financial power to combat panic and contain contagion seems to be the only effective remedy in the short term. Money, alone, however, is not sufficient to resolve the crisis. As it is evident from the analysis so far, underlying the problems of governance reform is a lack of trust among the members of the union. The expression of solidarity, in the shape of either unlimited ECB bond-buying or issuing Eurobonds, is blocked by the fear that those at the receiving end will fail to pursue agreed fiscal policies and reform agendas. As Jens Weidmann, the Bundesbank President, has put it: *"There's also a risk that you mute the incentives that come from the market...Market interest rates do play a role in pushing governments towards reforms"*.

In theory, of course, this problem is addressed by promoting political integration, that is by transferring sovereignty from national to European institutions. As already suggested, however, the politics of reform is complicated. Sovereignty transfers must be substantial if credible mechanisms for imposing discipline and securing stability are to be created. Such transfers generate strong resistance

from national power centres. Budgetary sovereignty is very close to the heart of most parliaments, including the German one. Automatic sanctions for excessive deficits are opposed by systematic sinners. Even within the EU, transforming the EC into a democratically elected European government will significantly reduce the power of national governments as exerted through the Council of Ministers. These resistances are reflected in public opinion and parliaments, making the process of winning majorities tortuous and quite risky. Evidence for this is offered by the rejection of the European Constitution project in a referendum held in France in 2005.

The difficulties in pursuing economic and political integration in practice go a long way to explain the present impasse. However, the endgame has been reached. Will Europe keep the single currency alive or let it fade into insignificance by restricting its application to only a handful of countries in the north of the continent while producing during this process enormous economic and social problems?

Answering this question cannot wait for long. In a positive perspective, the EFSF should be turned into a bank and be leveraged by the ECB so that it intervenes, massively if necessary, in the bond markets, keeping rates down and stabilizing funding conditions. At the same time, decisions should be taken for advancing economic and political integration. Announcing the issuance of Eurobonds and setting in motion a process to enact the legal changes needed coupled with the creation of a European Finance Ministry with substantial enforcement powers subjected to increased democratic accountability will contribute to calming the markets.

Such steps, on top of the considerable difficulties faced in taking them, inevitably ignite fears of moral hazard. In a nationally fragmented eurozone, will discipline and stability safeguards prove sufficient to set the union on a steady growth path? Or will they open the way for it to be transformed into the dreaded "transfer union"? Political risks, however they are addressed, should be weighed against financial and economic risks. Extended sovereign defaults and

bank bail-outs could carry unacceptable costs while bringing about a collapse of the eurozone and, perhaps, a global depression.

Greece's fate hinges on eurozone prospects. The chances for successfully exiting the crisis are maximized within the context of an effective European response. However, even in this case, it is extremely important for Greece to start delivering concrete results in the reform field in order to qualify for continued assistance.

The adjustment programme agreed with the troika (EC, ECB, IMF) was seriously flawed and poorly implemented. It placed too much emphasis on austerity, through tax rises and income cuts, and too little on reform. Loose planning and implementation failures led to a deep and prolonged recession which, through consistent undershooting of tax receipts, prevented a substantial fall in the budget deficit. In the absence of the devaluation weapon, the reverse should be the case: Less austerity and a longer time profile for deficit reduction, alongside an aggressive, and tightly monitored, pursuit of reforms so as to accelerate productivity growth and bring down domestic costs.

These defects should now be immediately redressed. Privatization, opening up of product, services and labour markets, deregulation, eliminating waste in the state sector, abolishing unnecessary public entities, should proceed at a fast rate in order to improve the investment climate and create conditions for economic recovery. An EU-led investment drive, financed by grants and EIB loans, will help to accelerate the pace of recovery. A shift in tourism towards the high end of the market, renewable energy, outward-looking agriculture and technologically intensive manufacturing are elements of a successful export-oriented strategy spilling over to more traditional sectors such as construction, real estate and financial services. A return to growth, in conjunction with tight fiscal discipline, will set the economy on a virtuous circle of lower deficits and interest rates feeding back to investment, exports and growth.

The alternative is default opening the way to a euro-exit. Arguments in favour of returning to a national currency are unsound. Devaluation would inflict further

substantial losses in real incomes – on top of those already incurred – and lead to the collapse of the banking system and capital flight of potentially very considerable proportions. Greece's debt position would worsen dramatically after taking into account the new currency denomination while inflationary wage rises – to compensate for income losses – would eventually wipe out the benefits from the devalued currency. Higher inflation and interest rates would condemn the economy to prolonged stagnation at depressed levels of output and employment. Social unrest and instability would inevitably follow, posing broader geopolitical risks.

The benign scenario I have outlined, for a euro-sustained return to solvency and growth, is feasible on two conditions. First, European help, provided that the eurozone moves to put its house in order. Second, a competent reform-minded government. Greece suffered from very poor governance over the last few years. The outcome of the next elections, due to take place at the end of February 2012, is critical for the country's future. The following months will determine economic and social developments for decades to come.

Greece's dilemmas are essentially political. The political system, as it is presently structured, seems unable to respond to the challenges. It is too closely tied to the problems it ought to confront. A major realignment of forces is called for, within or across parties, so as to create space for a new progressive line-up that would lead the way to recovery in conditions of social cohesion and fairness.