Europe & Greece: From Crisis to Growth

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November 1, 2012

MEGARON - THE MUSIC CENTER OF ATHENS
GREECE

I.

I. **The unholy Trinity of the EMU crisis**

II. Can Greek growth come back in a period of austerity?

I. THE UNHOLY TRINITY: THREE INTERELATED LEGS OF THE EMU CRISIS

Sovereign Debt Crisis

Austerity measures due to sovereign stress weaken economies

Real Economy Imbalanced & under Stress

Weak growth makes certain indebted sovereigns insolvent

Too many bank failures bankrupt sovereigns as they try to support banks

Sovereign defaults bankrupt banks with sizable sovereign debt holdings

Weak banks will slow growth through reduced lending

Weak economy & falling asset prices damage banks' balance sheets

Banking Crisis

- In Greece,
  - Sovereign debt & competitiveness were the two initial crises
  - A slow run on deposits & the PSI, created a banking crisis later

Source: BPEA (2012)

I.1 POLICIES TO REDUCE THE DEBT-TO-GDP RATIO

1. **Country Bailouts** – the "no bailout" principle was abandoned
   a) Bilateral loans, originally at punitive interest rates
   b) Creation of EFSF (ESM) but the back stop is small and the agency has little freedom to act
   c) Haircuts on sovereign debt held by private sector. Greek PSI, supposedly voluntary, it came too late to reduce the size of debt substantially, **worsened the banking crisis**

2. **Austerity** measures to generate primary surpluses
   a) **Problem** as a primary surplus affects the economy negatively, **reducing the growth rate,** often causing a rise in debt-to-GDP, hence worsening the sovereign crisis
   b) Recent **IMF & Eurobank studies** show that the **negative fiscal multiplier is higher** than previously thought and incorporated in the MoUs signed in the different crisis countries

I.2 POLICIES TO REBALANCE THE ECONOMY AND BRING BACK GROWTH

1. **Structural reforms**
   a) They improve potential output, e.g. Deregulating retail markets, liberalizing professions, streamlining rules for investment, make labor markets more flexible, etc.
   b) Most of them do not carry a fiscal cost, only political costs
   c) Yet today's problem in Greece is lack of demand and policies that improve supply in the long-run may cause a further contraction in demand
2. **Internal devaluation**
   a) Hard to accomplish in an environment of low inflation as prices are sticky downward. Few are the successful cases of internal devaluation: Hong-Kong (1990), Japan (late 90s-early 2000), Ireland (2008-present), Latvia (2008)
   b) The reduction in wages do not necessarily translate into lower prices, especially when labor cost is a small fraction of producer prices, only 22% in Greece. In addition, product & labor market reforms were delayed. They should have preceded the labor reforms (Hardouvelis(2007)).

I. 3 POLICIES TO RESOLVE THE BANKING CRISIS

1. **Stress tests**
   a) **Did not work** since they avoided to include the scenario markets were afraid off: A sovereign default. In addition, the backstop for the capital needed were the local governments, often too small for the task
2. **Liquidity provision**
   a) SMP was too small
   b) LTROs only after the Italian crisis in the summer of 2011. Even here ECB merely lends with collateral, it is not taking bad assets out of the system like the FED did in 2007-2009. LTROs can be used to fund the governments and increase the banks' dependency on the State
   c) OMTs with strict conditionality, Spain has to make a move now
3. **National Bank support & bank bailouts**
   a) Support schemes from late 2008
   b) Bailouts transferred the debt to tax-payers and caused sovereign crisis in Ireland
4. **Discussion for a Banking Union**
5. **WRONG POLICY: Increase in capital requirements**
   a) A pro-cyclical policy that causes banks to sell assets and refrain from lending, hence **worsening the economic slowdown**

I.4 POLICIES FOR THE SUSTAIBABILITY OF EMU

EMU leaders seem to follow rather than lead markets. Yet, for EMU to survive it cannot stay still. It needs bold policies that turn EMU closer to an Optimum Currency Area. This means closer unification.

i. **Proceed with banking union policies beyond a common regulatory framework to also a common resolution scheme with a fiscal backstop**

ii. **Proceed with deeper fiscal integration through Eurobonds in the form of e-bonds and blue-red bonds, through a common unemployment insurance framework, through an increase in the central EMU budget. Fiscal Compact is not enough.**

iii. **Establish policies that improve labor mobility across the Euro Area, e.g. common pension policies, common tax policies, etc.**

IN ADDITION,

i. **Follow expansionary fiscal policy in the EMU North (politically difficult) in order to generate demand in the South and resolve the imbalances within EMU**

ii. **Help heavily indebted countries in their debt sustainability efforts**

   a) **Allow crisis countries to enjoy positive inflation despite their internal devaluation, hence let ECB interpret price stability as a target inflation of larger than the current 2% , so that Northerners can have inflation > 2%**

   b) **Capitalize problematic banks directly from the ESM without raising national debts**

II.

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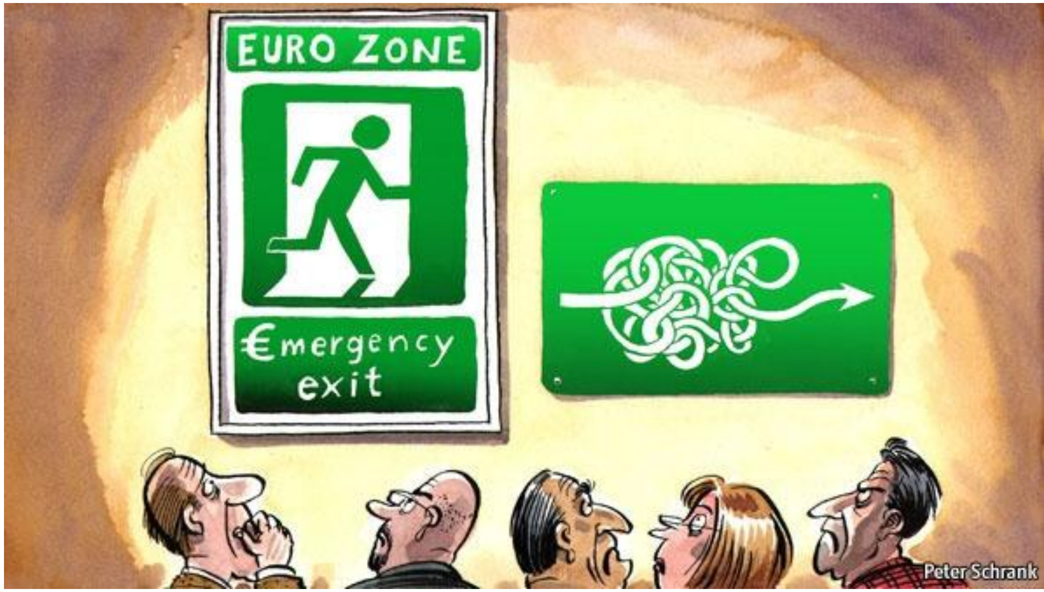


II. IN GREECE, GROWTH IS KEY

- From the three legs of the EMU crisis (sovereign debt, competitiveness & growth, banking), Greece's main problem is the real economy
- Growth is the number one priority at this moment as the recession continues
- Debt-to-GDP is growing to unprecedented levels , **190%**, but its sustainability is mainly a function of the evolution of future nominal GDP and the ability of the economy to deliver the interest payments, hence growth is key to resolving the sovereign debt crisis
- Growth is also key to resolving the banking crisis
- For attaining a new equilibrium growth path, concerns about the long-term structure of the economy have to be balanced against concerns about the continuing recession

II. REQUIRED REBALANCING IN THE COMPOSITION OF GDP

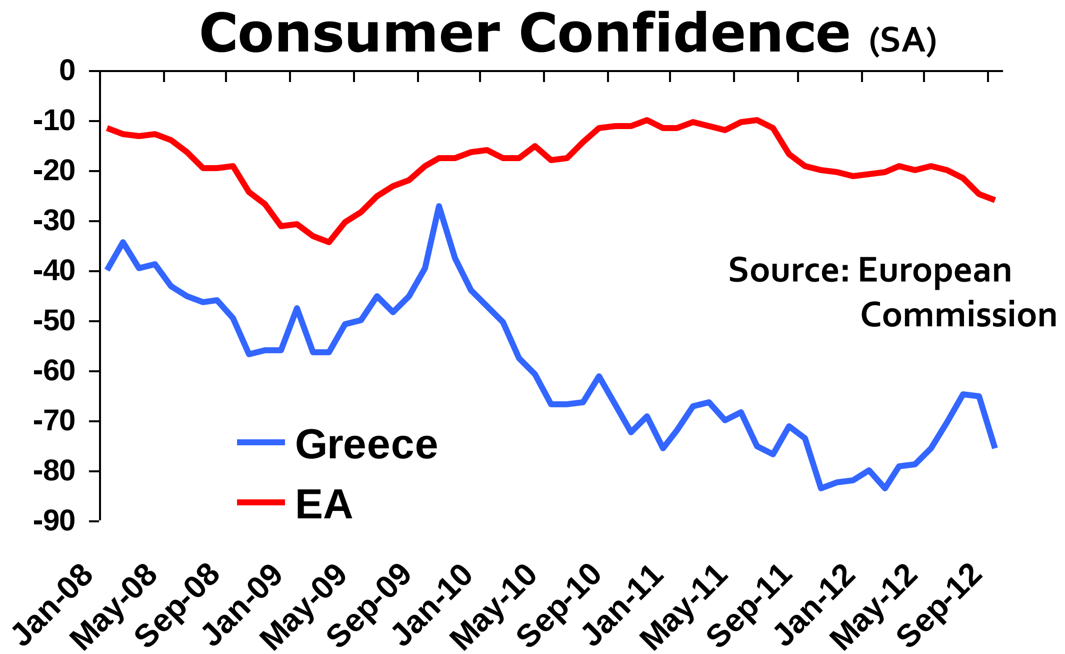
- Greek society over-consumes and under-produces, as evidenced by the large share of private consumption in output and the large gap between exports & imports
- Private investment share is dangerously small, around 11% of GDP from 19% prior to 2008
- Future generations inherit debt and lower capital stock!

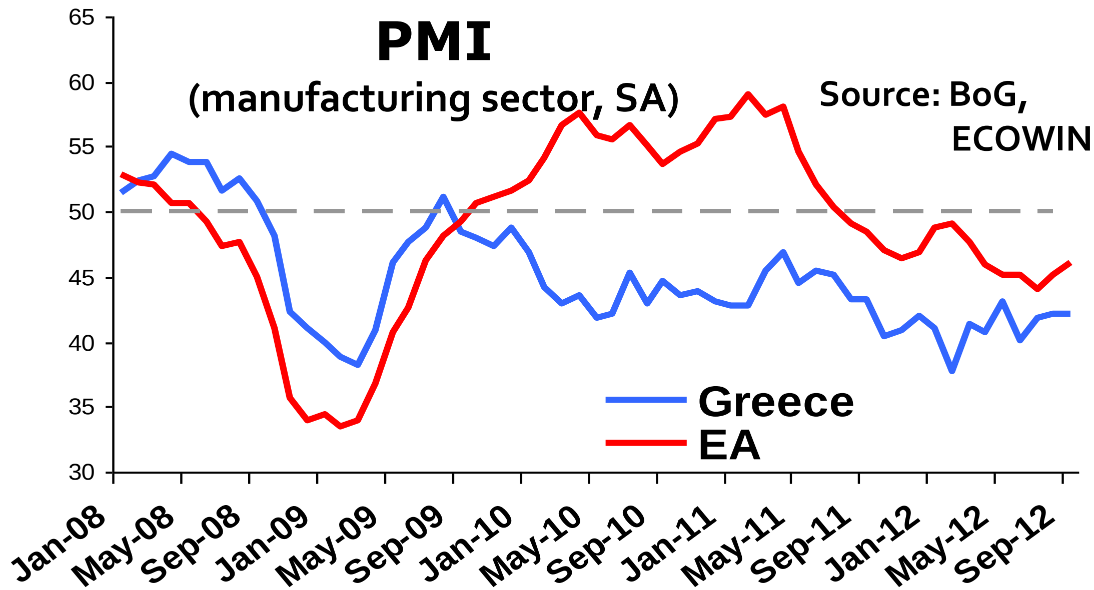
(2011, % of total GDP)	Greece	EA-17
Private Consumption	**74.6%**	**57.4%**
Public Consumption	**17.4%**	**21.6%**
Private Investment	**11.3%**	**17.1%**
Public Investment	**2.9%**	**1.7%**
Exports	**25.1%**	**44.0%**
Imports	**33.1%**	**42.6%**
GDP (€ bn) - 2011	**208.5**	**9420.6**

- In 2011, depreciation was larger than new investment, resulting in negative net investment and a destruction of capital stock
- Public investment (although larger than EMU average) is much lower than in the past and declined instead of going up to counter the current recession
- The reduction in the share of consumption in output is necessary, yet it has to proceed smoothly to avoid an economic crash

II. AT TIMES OF AUSTERITY, FOR THE RECESSION TO STOP, A NUMBER OF PREREQUISITES EXIST

- Political stability & Credibility, which would improve if,
  - Troika gives green signal
  - Reforms proceed at a faster pace, particularly the taxation of self-employed
- Liquidity, which is a suffocating constraint even for exports, thus front-loading the economy with cash rather than fiscal measures ought to have been a top European policy in the bargaining process
- Reversal of Sentiment and investment pessimism
- Increase in Public Investment
- Restructuring of the State sector





SUMMARY

- **Policy makers in the Euro Area ought to aggressively pursue policies that strengthen the Union, like banking union, a form of Eurobonds, a common policy on unemployment insurance, a more flexible ESM, etc.**
- **Greece has to stop the vicious cycle of austerity & recession**
  - Requires credibility, liquidity, improved sentiment
  - Europeans had to act smartly and front-load the economy with cash, not expenditure cuts - Instead they piled up the economy with €19 billion of new measures up to 2016, €13.6 of which will be instituted during 2013-14 (€9.2 in 2013 & € 4.4 in 2014)
- Greece has to **revamp its tax collection mechanism** and **jump start privatizations, free up its product & service markets and re-organize its State sector**
- Improved cost competitiveness, a new export-led economic paradigm, a re-capiltalized financial sector and structural reforms imply that once recovery starts**, growth can take off**

Thank you
for your attention

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I wish to thank my colleagues at Eurobank for their comments