Greece in the post-Crisis European Monetary Union

by

Gikas A. Hardouvelis
University of Piraeus

Sponsored by the Columbia Alumni Association of Lebanon
Presentation at the American University of Beirut, Suliman S. Olayan School of Business, Maamari Auditorium
Thursday, February 25, 2016, 18:00

Greece in the Post-Crisis EMU

The Greek/EA crisis of the past 6 years has generated a debate on two central questions:

I. Is the Euro Area strong enough to survive the next economic crisis?

II. Will Greece be a member of the Euro Area over the next decade?

Can EMU survive without Greece? The two earlier questions may be inter-related

I. Some argue that if EMU acts tough on Greece and abandons the irreversibility principle, it would soon unravel because:

- In the future, in the next economic crisis, markets would attack the most vulnerable member at that time and force it to quit
- In the future, some EMU members, if under stress, may choose to follow the Greek example
- Today, if another crisis hits Europe, like the refugee crisis or the possibility of BREXIT from EU, then EMU itself may be under stress

II. Others claim the opposite: EMU should act tough and discipline Greece.

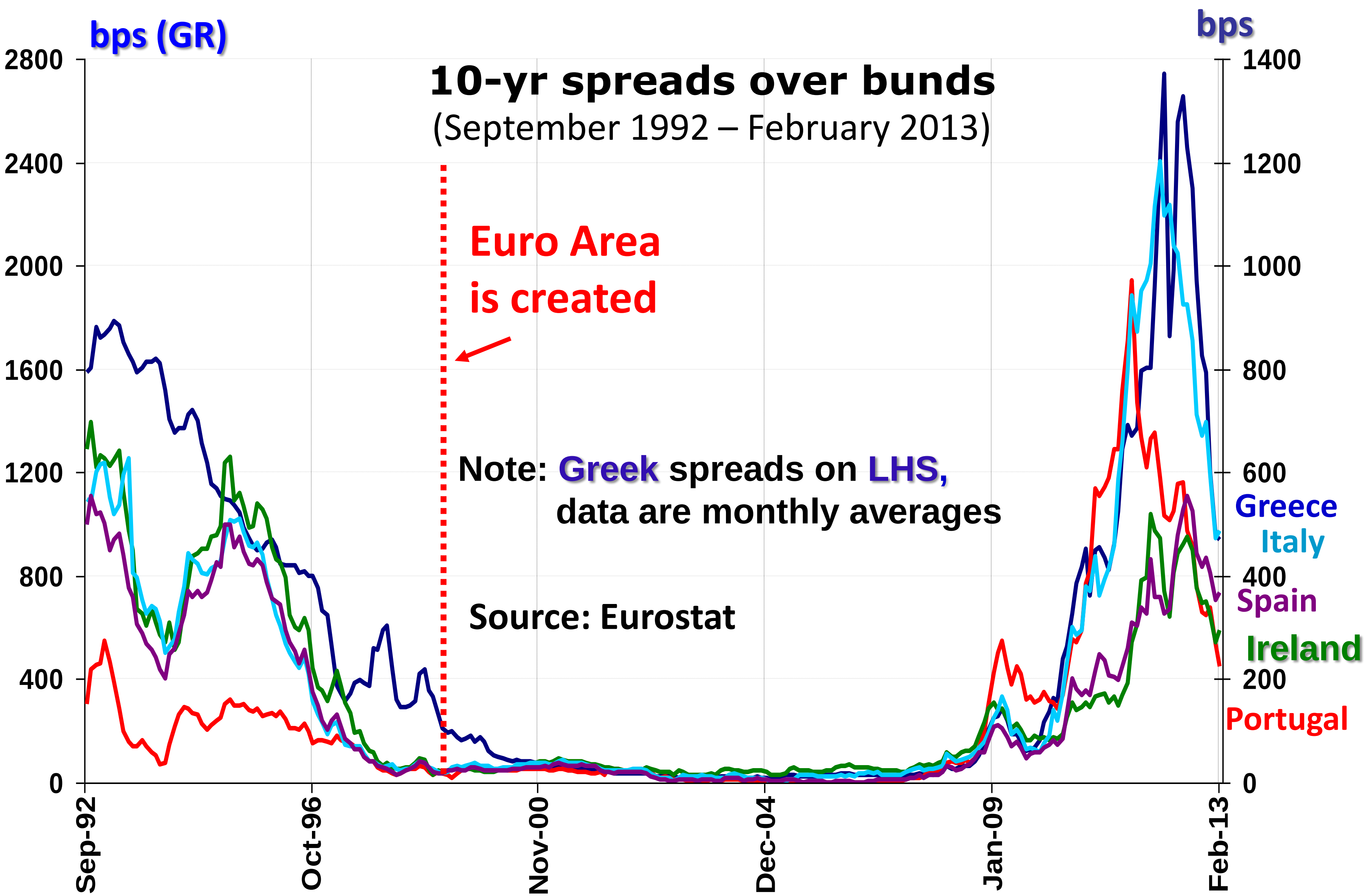
- In the absence of central EMU budget and a fiscal transfer policy, EMU cohesion rests on following strict fiscal rules. If Greece is allowed to misbehave, this destroys the rules, it creates moral hazard and copycats
- Kicking Greece out would force everybody else to obey the rules, which would stabilize EMU

III. Naturally, EMU does not like to kick a country out, yet it also dislikes the break-up of rules. As we will see, the new Greek government of January 2015, took an aggressive stance, disregarding the moral hazard issue

Will EMU survive ?

- EMU was not an **Optimum Currency Area** from its inception in the early 1990s
- An OCA requires **not only open borders** in the movement of goods & services, capital, and labor, but also
  - ✓ Similar economic structures, rules and institutions across the various country members
  - ✓ A more centralized fiscal policy with transfers between the regions or countries.
  - ✓ A banking union
- EMU was a **political project**: A common monetary policy was forced on the countries, and the hope was there would be real convergence in economic structures, i.e. that politicians would be pressured to do structural reforms that would make all EMU economies similar.

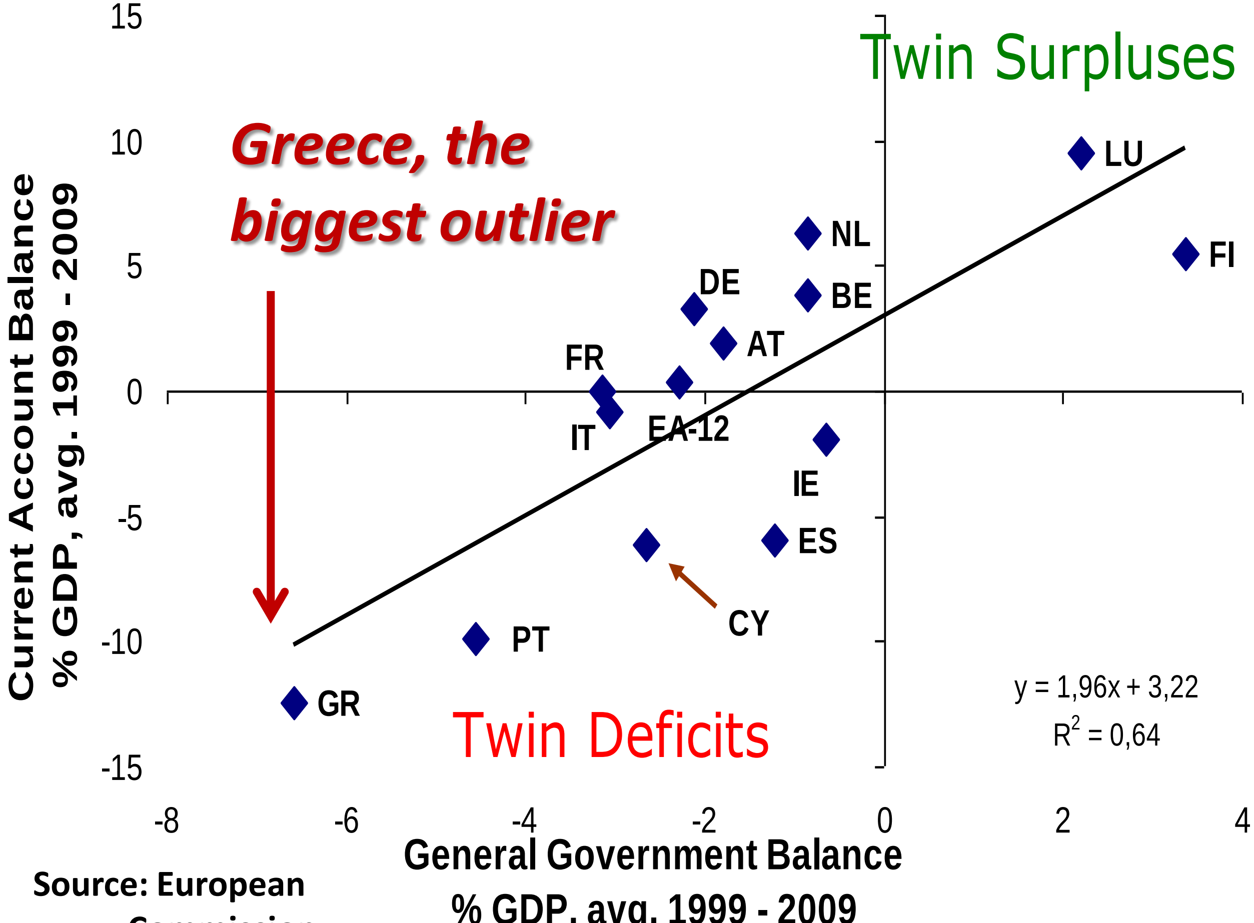
The Market View of EMU



EMU sad story: Instead of real convergence, serious imbalances …

- **Market failure:** Markets ignored the differences between countries and lent easily to both private & public sector
- Two major imbalances , fiscal & external (competitiveness)
- Greece was an outlier in the Euro Area

Eurozone Years up to the Greek Crisis



Source: European Commission

- Other imbalances: Private sector credit, which became apparent in the international crisis

Euro Area sluggish in responding to the sequential Crises

- After the 2007/2008 crisis, EA followed the coordinates actions of the G-20
- Although it had a banking problem, it was not as aggressive as the US
- Very sluggish in responding to the Greek crisis in 2009/2010, always behind the curve
- EA worried about its architecture . It could not follow expansionary fiscal (or monetary) policy in the fear it would create moral hazard.
- Its strategy was <u>not to extinguish the crisis</u>, but contain it and buy time
- Failed in the macroeconomic front: GDP has not grown since 2008, unemployment from 7.5% in 2007 to 10.9% in 2015, fiscal policy from 2011 to 2013 was pro-cyclical when reality said it should have been counter-cyclical
- There was some internal adjustment in reducing the current account deficits
- A lot took place in the <u>EA architecture</u> and a lot is still missing:
  - ✓ <u>Banking Union</u> and SSM
  - ✓ <u>European Stability Mechanism</u>
  - ✓ <u>Monetary policy</u> more responsive to the needs of the macroeconomy
  - ✓ Stricter fiscal rules, discussion of a <u>common fiscal stance</u> has begun
  - ✓ Yet, no effort for a common central budget, e.g. common unemployment insurance, common Euro-bonds
  - ✓ My view is: a common budget only after economic structures converge

So will the Euro Area Survive?

- Going back to the first question:

  I. Is the Euro Area strong enough to survive the next economic crisis?

- The answer depends not only on the economics but also on the evolution of politics
- I tend to be optimistic: My answer is yes as long is EMU continues to adapt, but the risks are multiplying

II. Will Greece be an EA member in the future?

- Recall that by 2014 the economy had cured its major macroeconomic imbalances and had stabilized; It grew at 0.7% and was ready for a major take-off
- Yet 2015 brought a new recession! Why?
- Because six years of suffering by the population brought a previously marginal and untested political party to power
  - The new government followed a collision course with the lenders but avoided GREXIT in the last minute
  - Yet the new government is slow to address the problems of the economy and now the country struggles again with the living standards declining
- Today the risk of GREXIT remains high but is not out of control

Misperceptions about Greece

MYTH #1: Greece used faulty statistical data to enter EMU

MYTH #2: The Goldman Sachs interest rate swap reduced the size of debt, helping Greece enter EMU with lower than the real Debt-to-GDP ratio

MYTH #3: Greece was the first country to violate the Stability and Growth pact

MYTH #4: Greece did not achieve much regarding structural reforms implementation under the 1st and the 2nd bailout program

MYTH #5: Greece did not achieve much in fiscal consolidation

MYTH #6: Public Debt was unsustainable at end-2014

MYTH #7: There was no investment interest for Greece

MYTH #8: A Grexit will improve the prospects of the Greek economy in the medium term

MYTH #9: Greeks are lazy

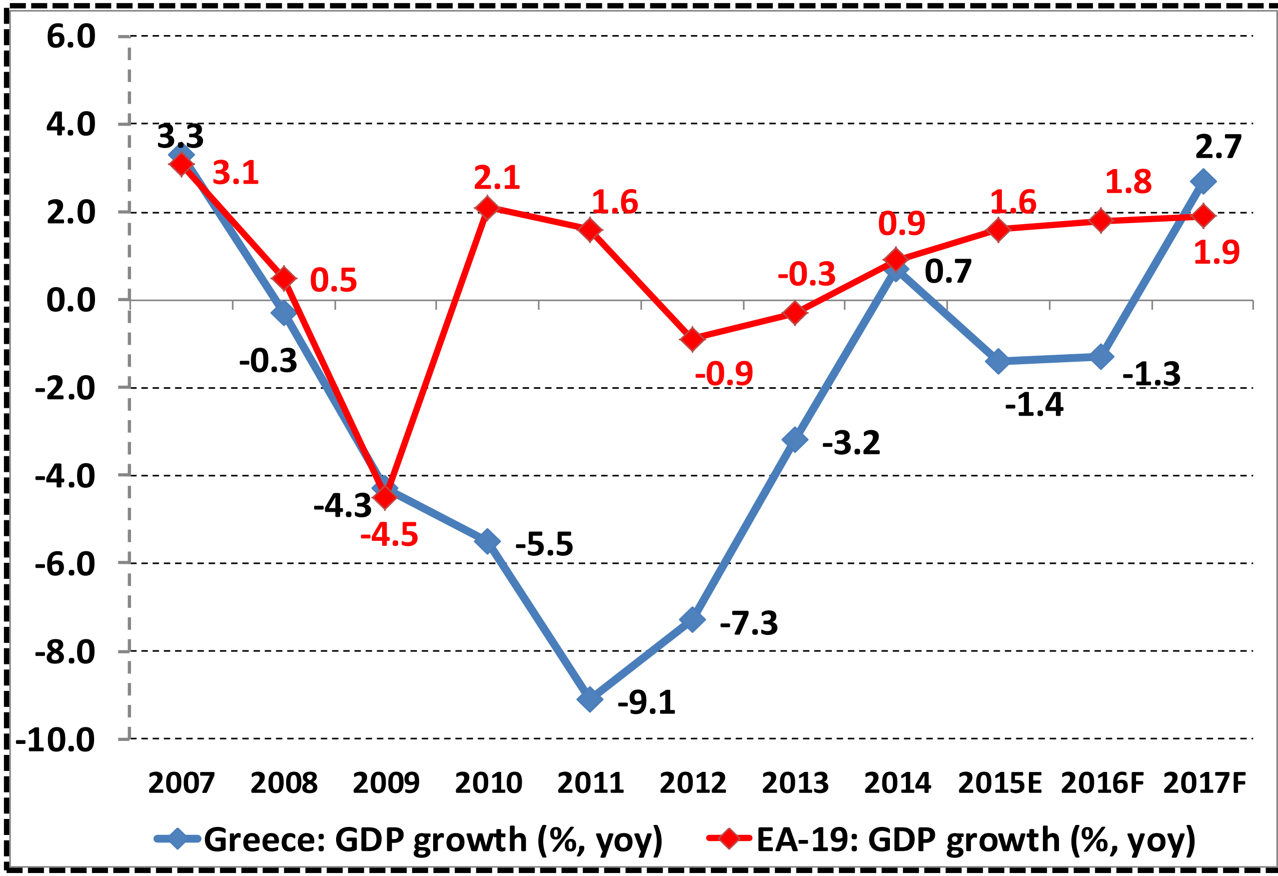
MYTH #10: Greeks are wealthy because they do not pay their taxes

MYTH #11: Greeks are in a natural constant turmoil

MYTH #12: The excessive behavior of Greek banks caused the country to suffer

Why such a huge recession until 2013?

1. Macroeconomic imbalances worse than anywhere else in the Euro Area
2. Closed economy, dominated by small firms, with inefficient public administration, unstable tax policies, …
3. Liquidity crunch
4. Serious program errors by domestic politicians and lenders



- Parties in opposition consistently took extreme positions, unlike in other programs countries. Hence, no ownership of reforms, "MoU " a dirty word
- Lenders insisted on the wrong sequencing of reforms

5. A "political shock" in 2015, brought a W-shaped recession

State of Play at end-2014

- Imbalances were almost cured (fiscal, competitiveness), with Greece improving in many competitiveness indices
- Economic growth resumed (+0.7% in 2014), with sentiment rising, investment turning positive and unemployment declining
- Investors had come back to buy domestic firms, privatizations began taking off, large private firms were able to issue debt in the international market
- 2015 growth was expected higher than at 2.5%. The 2015 budget was balanced like in Germany
- Greece was ready to almost leave the lenders' bailout PROGRAM, like Ireland and Portugal had done before. Government had secured a credit line from the Europeans (ECCL) with €11bn HFSF pre-existing funds. The IMF money was going to be added to that pool.
- Debt was on a sustainable path, assuming growth would continue.
- In Nov 2014, little remained to close the final review of the 2nd Program:
  - At the Eurogroup meeting of December 8, 2014, EU Commissioner Pierre Moscovisi stated: "*Greece has done more than enough to close the review and a lot more than any other Program country.*"
  - The IMF and ECB did not agree

What went wrong since January 2015?

- Inexperienced government, MPs kept promising more after the elections!
- Ignored the supply side of the economy, instead made nominal debt haircut central issue
- Misjudged the European side's maximization problem
- Did not attempt to close the Review, hence were deprived of cash. Thus arrears went up to €7bn, drying up the liquidity of the private sector, plus €7.6bn were squeezed out of the state entities' cash buffers
- Created anxiety among the population, who gradually pulled more than €40bn from the banks or 25% of their deposits.
- By June, PM was about to close a deal with €9bn worth of measures he had proposed But he had an internal problem within SYRIZA. Not only would he fail to deliver on his pre-election promises of €10bn more in expenditure, but he was about to sign a much worse deal than the previous government, raising taxes and cutting wages and pensions. So he called a referendum. The referendum had a very ambiguous question.
- The announcement of the referendum created a bank panic, which immediately led to a bank holiday and capital controls
- July 5th referendum delivered a decisive NO to austerity, yet subsequently the PM, within a few days, did the opposite of the referendum result. This way he avoided the sure Grexit, as the country was desperate for cash.
- Leftist opposition of SYRIZA split off and formed a separate political party.
- SYRIZA did not want to govern as a minority government. Elections were thus called for September 20th. SYRIZA won again with 35.5% of the vote. A new SYRIZA –ANEL coalition runs the country.

Current State of Affairs

- Full year 2015 contraction of -0.7% instead of the original growth of > 2.5%
- Up to November 2015, Bank stock prices collapsed, hence State lost over €20bn, plus now it has a much lower presence in bank stocks
- Expectation of full year 2016 contraction, with possible recovery in Q3
- According to the IMF, Public debt no longer sustainable
- Economic sentiment very low
- New program envisages full coverage of State borrowing needs until 2018, plus a new OSI would be likely after completion of the 1st review
- The 3rd MoU is increasing debt by approximately €45bn or 25% of GDP. This is more than zero, under the previous government's targets, but smaller than the total package of €86bn, as a big chunk refinances existing debt.
- Yet cost to the economy also includes Loss in value from the State holding of bank shares plus the loss in GDP

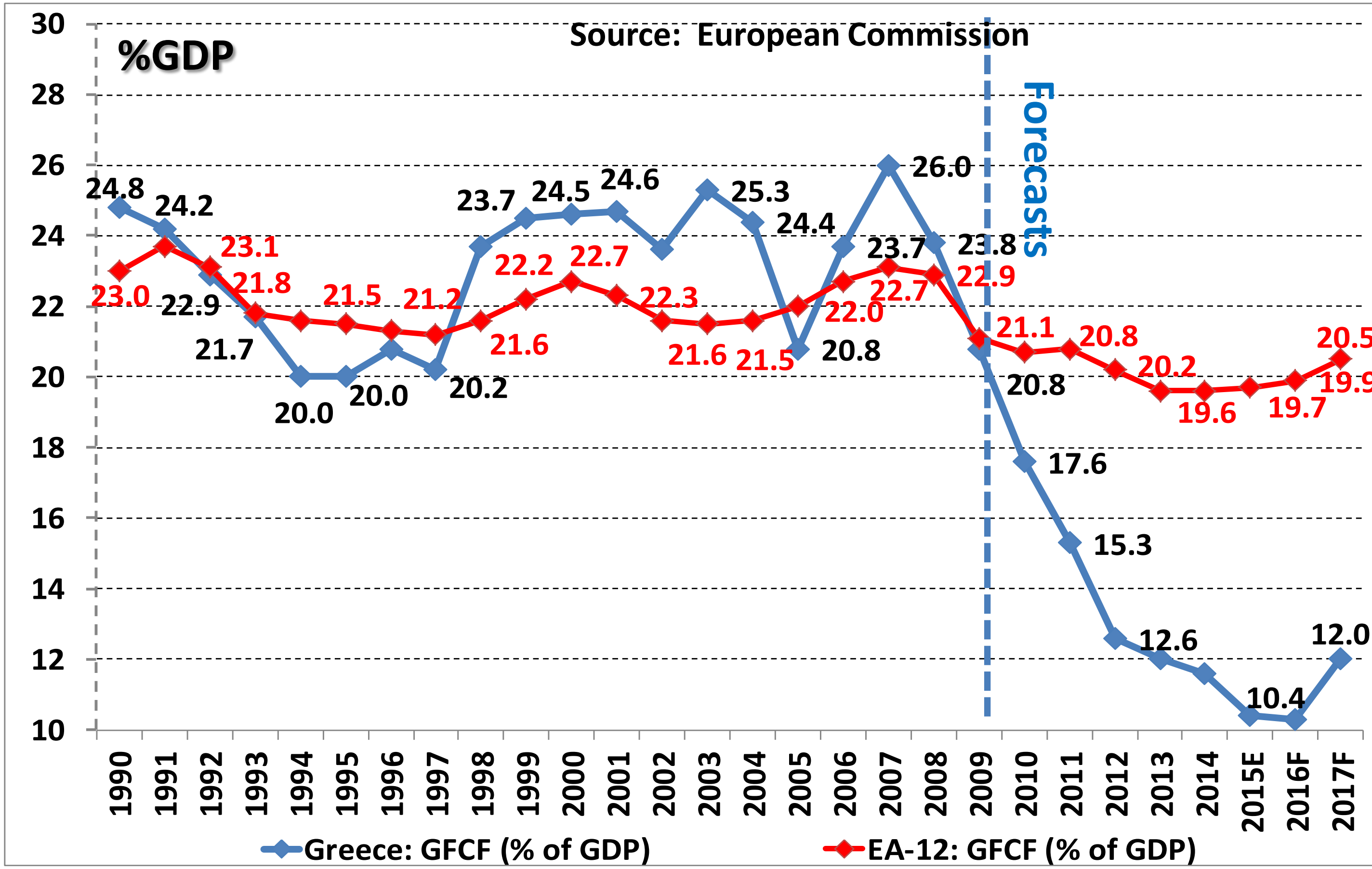
Can growth come back? Is it just a 2-year delay?

A yes answer implies the risk of GREXIT diminishes
But is it a YES answer?

- Economic policy remains unfocused
  - There is no clear growth strategy, no commitment for reforms
  - The first Review of the 3rd program was supposed to have been concluded last October. Yet, there is doubt it would conclude even before the Greek Easter. An issue of contention is the design of the pension system. The IMF insists on its long-term sustainability.
  - Meanwhile the Greeks are been overtaxed and began resisting, from white-collar processionals to farmers
  - And the government keeps hiring new public employees through the back door!
- Meanwhile, since January 2016 the bearish world market has taken a toll on Greek bank stocks, which are down 60% relative to the recent recapitalization of November 2015. Their NPLs keep rising.
- And there is a refugee crisis

Investment is a binding constraint on growth

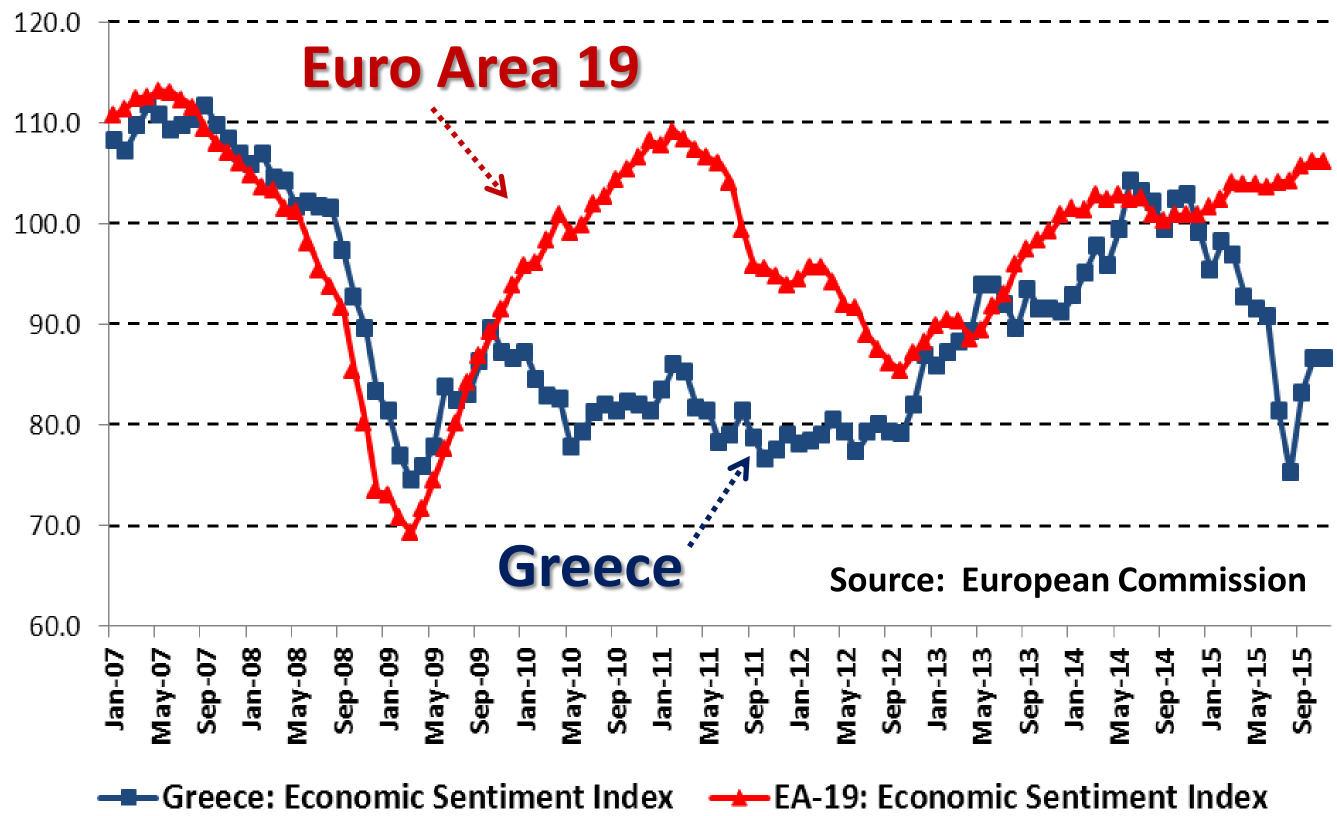
- Assuming the economy manages to stabilize, the challenges are many, including Investment
- Investment needs funding, FDI, EU funds, the Junker plan



- It will be difficult for Investment to reach the pre-crisis shares of GDP, as real estate investment will take time to recover
- What is needed for growth today is Investment in machinery & equipment

At a minimum, new investments require State credibility and improvement in sentiment

- The sentiment index in Greece moved together with sentiment in EA until late 2009, both declining
- Decoupling during the Greek crisis
- From late 2012 on, Greek sentiment moves upward and again together with EA sentiment



- Greek sentiment peaked in the period June 2014 - November 2014, but subsequently began a fast downward slide as the political landscape deteriorated and generated new uncertainty, thus decoupling a second time from the rest of EA

Summary: An uncertain future ahead of us

- Europe faces major challenges
- Greece faces even bigger ones
  - The risks today are bigger than last summer as their resolution requires hard work by many, not just political will by some
  - The last 6 years surprised everyone at how much pain the Greeks were able to sustain. Pessimists are likely to be surprised again

Greece in the post-crisis European Monetary Union

Thank you for your attention!

Gikas A. Hardouvelis

AUB 150 | 1866 AUB American University of Beirut الجامعة الأميركية في بيروت

Appendix: The August 2015 3RD MoU with its 4 pillars

- ❑ **Implementation Period: 2015-2018,Conditionality will be updated on a quarterly basis**
- ❑ **About 220 actions, with 110 front-loaded until January 2016**

I. *Restoring fiscal sustainability*:

- ❑ More gradual fiscal path due to objective weakness: Primary surplus balance targets of -¼, 0.5, 1¾, and 3.5 % of GDP in 2015, 2016, 2017 and 2018 and beyond, respectively
- ❑ Tax policy reforms (Income tax revamp, eliminate exemptions, VAT, tax on farmers), minimize Arrears, central procurement, more savings from Pension expenses, reinstate reforms in Health Care, Roll-out GMI

II. *Safeguarding financial stability*:

- ❑ Recapitalization of banks before the end of 2015, tackle strategic defaulters, sell NPLs, new governance structure of HFSF & banks

III. *Growth, competitiveness and investment*:

- ❑ Reforms in labor markets & product markets (including energy) via business environment and competition policies
- ❑ Ambitious privatization programme

IV. *A modern State and public administration*

- ❑ Efficiency of judicial system, (Code of Civil Procedure, fight fraud & corruption)
- ❑ Institutional & operational independence of key institutions such as Revenue Administration & ELSTAT
- ❑ Pension reforms to remove exemptions, end early retirement
- ❑ Fiscally-neutral Wage Grid, Better recruitment process for Managers
- ❑ Rationalization of SOEs