

Crisis, Threats and Ways Out for the Greek Economy†

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Abstract

The article describes how the unprecedented public and current account deficits that occurred in Greece over the last few years led to the current debt crisis in the aftermath of the global financial crisis of 2008. Some policy directions for achieving fiscal stability and restoring growth and competitiveness in the Greek economy are also discussed. The fact that the twin deficits became unmanageable only recently suggests that the underlying factors of the debt process can be feasibly adjusted back to sustainable levels, so that default or debt restructuring options are completely avoided.

Keywords: debt, public deficits, debt crisis, Greece.

1. Introduction

It is now widely recognised that the current Greek debt crisis, which was triggered by the international financial crisis of 2008, grew out of Greece's simultaneous exposure to a combination of persistent fiscal and external deficits. During the 2007-2009 period both external and domestic imbalances registered a significant deterioration, which in turn led to a widening of spreads, the evolution of unstable debt dynamics and a complete collapse of confidence, especially from foreign investors.

2. How did it happen?

From the country's accession to the European Monetary Union (EMU) until 2007, public debt increased every year by an amount of EUR 7 to 12 billion, with a small exception in the Olympic year 2004 when it was augmented by EUR 16 billion, (Figure 1). Nominal GDP was expanding at

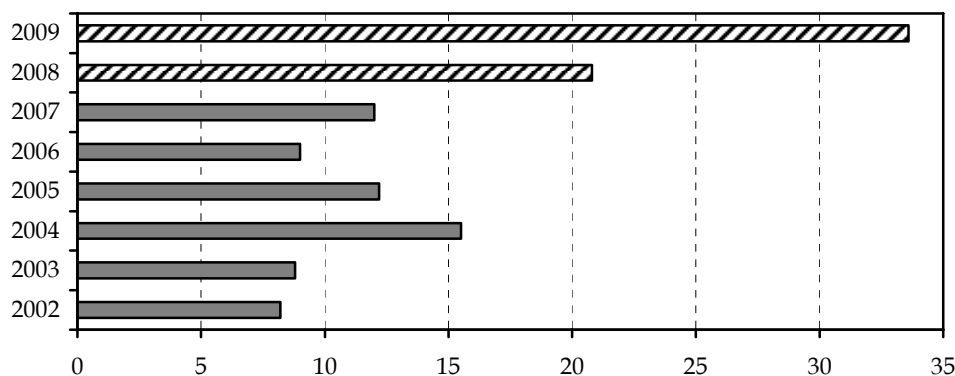
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a substantially faster rate due to the strong growth prevailing at that time, resulting in a steady fall in the country's GDP ratio. Greece was serving its obligations credibly, but also at a declining cost. It is, perhaps, worth remembering that during the period 2001-2007 the 10-year spreads were contained between 20 and 30 basis points above German bonds.

FIGURE 1

Annual increase of public debt, billion €



Note: Striped bars indicate the most dangerous deviations.

Sources: Debt of General Government, Eurostat, Budget reports data 2003-2010.

In sharp contrast, during 2008 and 2009 Greece added EUR 56 billion to its debt in a period of slow or negative growth. Thus, for the first time since Greece's accession to the EMU, its public debt started rising again as a percentage of the country's GDP and interest rates entered an upward spiral.

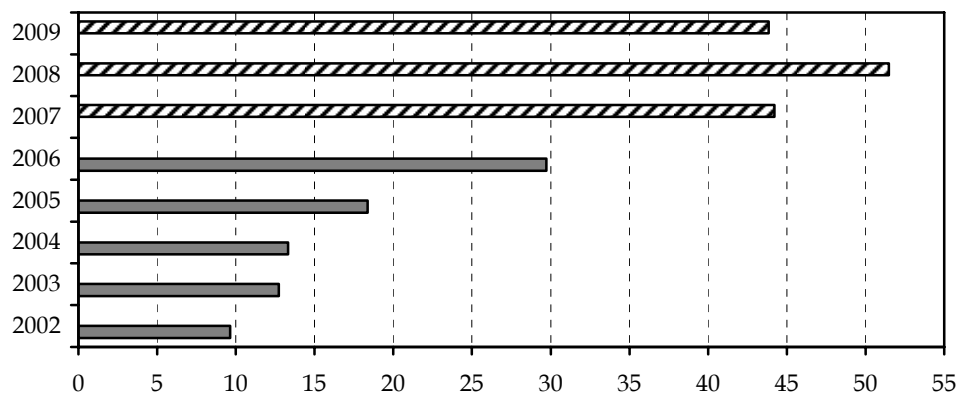
Interestingly enough, the deterioration of the debt situation in 2008 by some EUR 22 billion was comparable in size to the increases in debt levels in other countries, created in order to fund rescue initiatives for their banks and relevant support programmes. The resulting problem might have been manageable, had it not been for three more aggravating factors that caused a further rise in debt by another EUR 34 billion in 2009 and brought about the final blow to the Greek economy. These were the following:

First, it was the unprecedented expansion of Greece's external deficit that put considerable pressure on the balance sheets of the private sector. Of course, the balance of payments had always been in deficit in Greece, though not at such alarming levels. Before 2004 it was around \$10-12 billion per annum, thus easily ensuring its financing. In addition, the external deficit reflected, to some degree, the expansion of Greek business

abroad and as such it could eventually be counterbalanced by future profits. However, after 2006, external deficit soared, reaching \$52 billion in 2008, nearly five times the previous levels.

FIGURE 2

Current account deficit, billion USD



Note: Striped bars indicate the most dangerous deviations.

Source: IMF WEO.

No doubt, the rise in oil prices contributed to the expansion of external deficit by some \$6 billion, but the largest increase was the result of a rapid increase in imports, predominantly of consumption goods. Authorities appeared at ease with the ensuing consumption boom, never considering any policy measure that could reverse the tide. Quite the contrary, several policies were in fact exacerbating the consumption spree, such as, for example, a favourable tax treatment of offshore companies, the abolition of wealth determinants on taxable income, and a massive increase in wage remuneration in the public sector a few months before the elections. But perhaps the most paradoxical was the policy to reduce surcharges on imported cars, a decision that immediately worsened the Current Account and reduced much needed public revenues.

In more tranquil times, even such a huge deficit might have been easily financed either by the extensive inflows from the then booming Greek shipping sector or thanks to the overflowing international credit. The 2008 crisis, however, negatively affected international liquidity, both for the public and private sectors, and led to a significant widening of spreads.

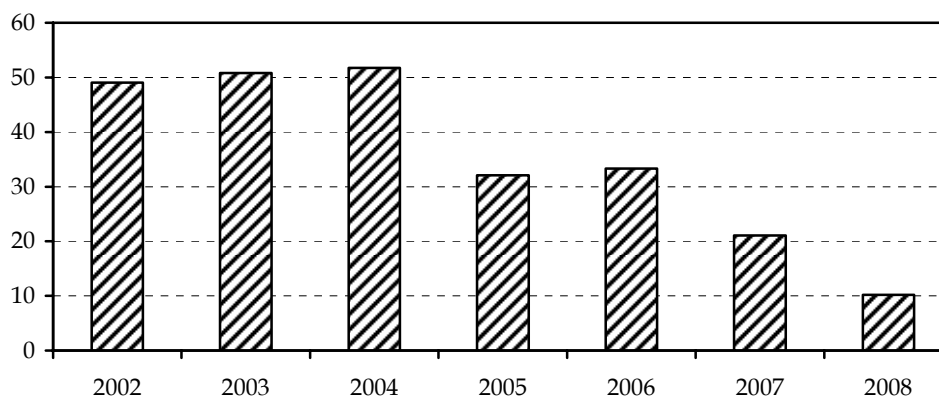
A second aggravating factor was the fact that the largest share of Greek public debt has been held by foreign banks; about 75% of total stock, compared with less than 50% a decade earlier. Before the crisis, relying on foreign lenders

may have offered a more flexible management of public debt, but it resulted in painful market pressure after the crisis. On the other hand, the heavy dependence abroad made more room available for the domestic banking system to expand consumption loans, which in turn fed the external deficit. Overnight, the crisis revealed the serious problems emanating from high foreign indebtedness of both the public and private sectors.

The third and perhaps most decisive factor behind today's crisis was the fact that the borrowing boom of 2008 was followed by an even stronger one in 2009 as a desperate move to reverse the gloomy situation prevailing in the country, as economic recession was accompanied by social tensions and repeated incidents of political violence. Public trust that the crisis could be managed was fading fast as an increasing sense of widespread corruption and public sector inefficiency spread. For example, the relevant World Bank Indicator for fighting corruption declined to extremely low levels by 2008 (Figure 3). Under mounting pressure, the Government called for an early election but, despite the huge pre-electoral spending designed to appeal to deserting voters, it was decisively defeated.

FIGURE 3

Control of corruption index



Source: World Bank, WGI.

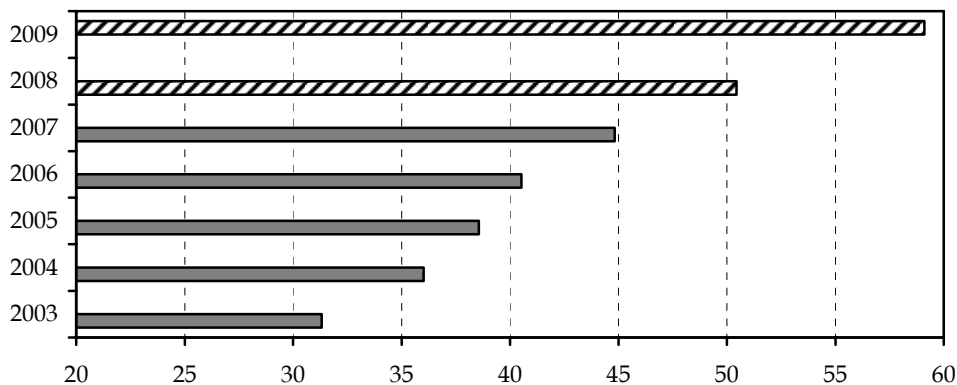
The combination of all the above factors led to an unprecedented deterioration of the fiscal position through the following channels:

1. Primary expenditures neared EUR60 billion in 2009, twice the size of those of 2003, and higher by 20% than the year before (Figure 4). Increases were mostly related to salaries and pensions (EUR+4.7 billion), various allowances (EUR+1.7 billion) and a huge rise in public consumption (EUR+2.1 billion). Because the increase in civil servants' remuneration was far greater than the figure implied by the official

incomes policy in the public sector, it is reasonable to assume that it was due to a combination of pre-electoral recruitments and clientilistic perks.

FIGURE 4

Primary expenditure, billion €



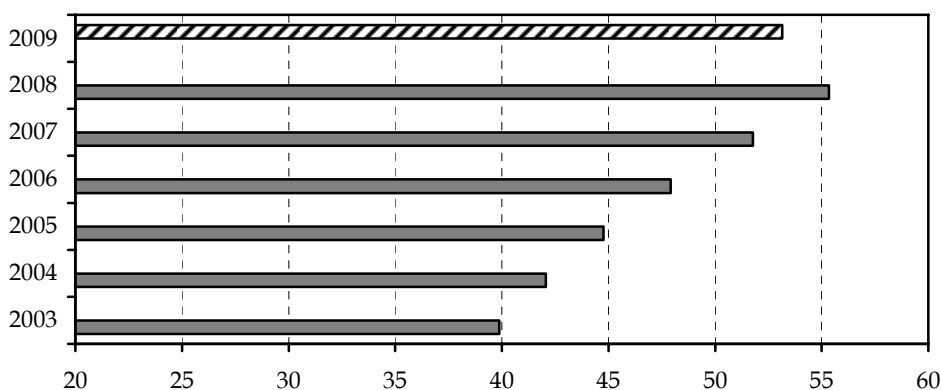
Note: Striped bars indicate the most dangerous deviations.

Source: Budget reports data 2003-2010.

2. Tax revenues for 2009 dropped by EUR-2.3 billion as compared to the 2008 amount (Figure 5). This was due partly to the expropriation of VAT receipts by small traders and partly to the reduced corporate tax rate (by EUR 0.5 billion). Putting together skyrocketing expenditures and reduced revenues, Greece suffered a primary deficit of EUR 6 billion for the first time in more than a decade. In the previous years primary surpluses were ranging between EUR 5 and 9 billion.

FIGURE 5

Public revenues, billion €



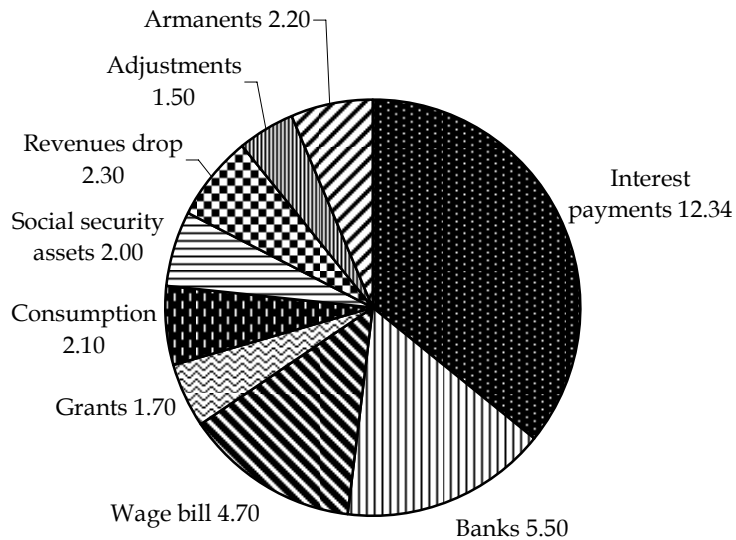
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Source: Budget reports data 2003-2010.

3. Other components of spending were also in full steam despite the dramatic deterioration of the fiscal position. In 2009, Greece continued to spend EUR 2.5 billion on armaments, while at the same time the government issued bonds of yet another EUR5.5 billion to support the banking sector.

FIGURE 6

Composition of the debt increase by EUR 34 billion in 2009



Note: With the exception of interest payments and the banks' rescue package, all other figures show increases over the previous year, thus contributing to the rise in debt.

Source: Budget reports data 2003-2010.

It thus becomes clear that the key factor behind the crisis Greece is experiencing today is the public sector's uncontrollable propensity to spend, especially in electoral times, and the lack of effective collection of revenues.

3. Some policy suggestions

In addition to the measures already implemented by the tripartite agreement between Government, EU and the IMF, the following policy directions should also be considered:

First, reverse as many as possible of the spending decisions for the wider public sector taken since the 2007, including those on recruitment and pay, before they become a permanent burden on public finances.

Second, establish constitutional provisions that prevent excessive borrowing, especially prior to elections.

Third, advance the privatization plan that has already been announced in the Stability Programme, but whose implementation is still pending. With the exception of some strategic businesses in the energy sector where the government should maintain a significant stake in view of future developments in the wider Balkan region, all the other profitable Public Utility Organizations (PUOs) ought to seek private financing through the issuance or direct sale of shares. At the same time, they should adopt wage and employment policies that do not seriously deviate from those in similar European businesses.

Privatisations can also be extended to deficit-prone PUOs, such as, for example, the Hellenic Railways Organisation (HRO). If better managed, HRO could turn into a double dividend situation: contributing towards fiscal consolidation, and at the same time boosting exports so badly needed to reduce the current account deficit..

Fourthly, while fiscal consolidation is a precondition for further progress, there is also an urgent need to deal with the problem of accumulated loss of competitiveness, which has induced large current account deficits. On average, Greek products and services are 25% more expensive than their counterparts in other Euro-area countries. Without an option of a nominal devaluation, deflation must occur differently, and the IMF has already declared that a reduction in nominal wages in the private sector will be necessary.

However, as the country already suffers from deep recession, a further deflation might further aggravate the situation rather than providing an exit from it. Price adjustment should take place by making firms behave more competitively, rather than through lower incomes.

Take, for example, retail prices: Since the 2008 crisis, companies in all European countries have cut prices in order to retain their customers and market shares. Exploiting administrative regulations and local market

rigidities, several companies in Greece have raised prices in order to maintain profits.

To avoid further recession, it is preferable that deflation is achieved only through a downward adjustment of non-competitively set prices, especially in state-regulated sectors. The Government can assist this situation through the liberalization of "closed-shop" practices and administrative price-setting in several sectors, from transportation lorries to lawyers' fees.

Concluding, the debt crisis in Greece could be contained by a combination of policies that reverse the recent spending spree, establish the long-term credibility of its fiscal management and open up investment opportunities to promote growth. Not an easy task, but totally feasible.