The Greek and EU crisis

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Greece has three big economic problems

- Significant public sector deficits
  - Very inefficient public sector; corruption in procurement
  - Tax evasion; need new tax enforcement
- Huge accumulated debt it cannot fully service, partially alleviated by privately-held bonds haircuts
- Lack of competitiveness caused by
  - Union power that has increased wages and salaries without productivity increases
  - "Closed" sectors ("professions"), including taxis, trucks, pharmacies, engineers, lawyers, notaries, ...
  - Fixed exchange rate (locked in the Euro)

Greece also has big social problems

- Law and order breakdown
  - Hundreds of strikes (see www.apergia.gr)
  - Hundreds of demonstrations
    - Downtown Athens has been burned a number of times by hooded “those against state power” even before the economic crisis
    - Murders at Marfin Bank of workers who did not strike
    - Last week the busts of Kazantzakis and El Greco were stolen right in front of the Academy and were melted
  - 2 mil illegal immigrants in a country of 10 million (official census 11.3 mil in 2011)
- “Golden Dawn” attempts to take over the functions of the police
- Sharp increase of drug addiction, especially among the immigrants

Greek economy at a glance

- Gross Domestic Product (roughly total production) $300 bil (2011)
  - Per capita income $27,000 (29th richest in the world)
- Greeks are much more prosperous than these numbers show
  - **"Black" (informal) economy about 30-40% on top of formal**
  - Including it would make per capita income $35,000-38000
  - Black economy does not pay taxes
- Main economic activities:
  - Services (including tourism) 85%
  - Industry 12%
  - Agriculture 3%
- Joined euro in 2001 at 340 drachmas to Euro
  - 15th largest economy among 27 in EU (without the black economy)
  - Largest economy than all rest of Balkans combined
  - Significant regional investor (Greece has invested extensively in the Balkans and Turkey)

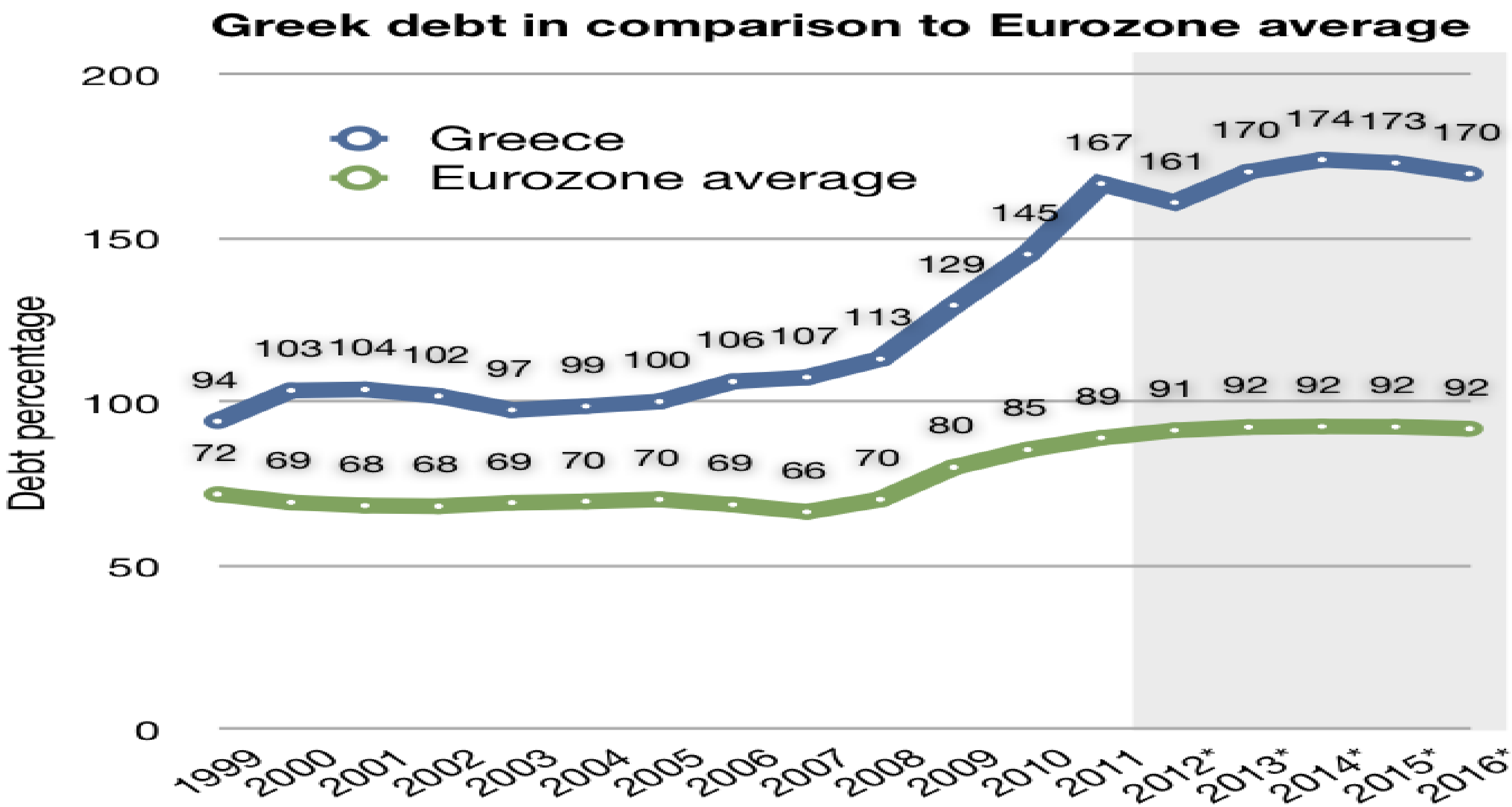
Long term adversary: Turkey

- Greece spends more as a percentage of GDP on defense than any other NATO country except the US
- Buys weapons from US, Russia, China, France, Germany, UK, Israel, ...
- Very small domestic arms production
- Had a relatively large conscript army until recently

Greece is bankrupt since 2009
How did it get there?

- From 1982 to 2009 Greece borrowed $300 billion, equal to its GDP in 2011
  - This is a debt of $27,000 per capita
- This is on top of another $300 billion of net transfers (gifts) to Greece from the EU
  - Greece received a whole year's income as a gift from the EU, and borrowed another whole year's income
- Even with all these moneys, Greece is bankrupt
- **The present generation of Greeks ate all its money as well as the money of its children and grandchildren!**

Debt as a percentage of GDP



Source: Eurostat
*estimates

Where did/does the money go?

1. State spending; because of corruption
   - Very excessive number of civil servants (800,000 in a country of 11 mil), 80% of the national budget
     - Could and should be reduced by 150,000
     - But, no elected political party supports a serious reduction!
       - Demonstrations even when only a 2000 cut was proposed
   - The state buys at very high prices (50-100% above competitive prices)
     - Very big scandals in defense dept. and hospital procurement
2. Inability of collect taxes
   - Corruption of tax collectors
   - Corruption of tax payers (at all levels of income)
   - 4-4-2 system explained by Prof. Diomidis Spinellis; tax collectors
     - Forgive 40% of the tax fine for underpayment
     - Ask for 40% bribe (under the table)
     - State collects only 20% of the total tax obligation

Dealing with the crisis: “Mnemonia” Memos of understanding between the creditors (EU, IMF, ECB) and Greece

- Mnemonio #1 (May 2010) (Papandreou – Papakonstantinou)
- $145 bil ($40 IMF, $105 EU); interest 2.5%
  - Reduce budget deficit (partially successful)
    - Cut wages and pensions
    - Cut public investment (wrong target!)
  - Civil servant salaries were cut to lower levels rather than reducing their number (big mistake)
  - Implement structural reforms in labor markets, opening “professions,” ...
    - Total failure; not a single profession has been opened

“Private Sector Involvement” (PSI) Greek Debt Not Held by the EU and IMF cut by 74% in March 2012: Debt Haircut

Mnemonio #2 (February 2012) (Papademos – Venizelos)

- Haircut on privately-held Greek debt
- Cut by 74% (approximately $107 bil)
- Significant new loans to Greece and Greek banks were required because 1/3 of the bonds were held by Greek banks and pension funds that needed to be recapitalized
- Net cut of the debt about $75 bil

Mnemonio #3 (December 2012) (Samaras - Stournaras)

- Banks received 50 bil for recapitalization
- Greece received continuation loans
- Greece promised to implement structural reforms (again)
  - For every installment of the loans there is renegotiation because typically Greece does not achieve the targets

Present economic condition

- Unemployment over 25%
- Youth unemployment 58%
- 5 years of recession
- Income down 20% (from 2008)
- Real income (adjusted for inflation) down 30% (from 2008)
  - Pensioners and the poor suffering
- More tax evasion than before

OPTIONS FOR GREECE

Three options available (March, 2013)

A. Implementation of structural reforms, staying in Euro

B. Rejection of lenders' terms, hard default, adoption of a new drachma (rejected by voters 7/12)

C. To make no significant changes, linger in the present swamp, leading to eventual bankruptcy ("death by thousand cuts")

In my opinion, "A" is by far the best

How should it be done?

Option A: Implement structural changes, stay in Euro

Option A: What needs to be done inside Greece (1)

Take immediate radical measures:

- Reduce the public sector
  - Cut the general (non-wage) expenses of the state; change procurement processes
  - Reduce the number of civil servants over and above the natural attrition of 5% by
  - (i) closing useless divisions
  - (ii) eliminating jobs that have been surpassed by technological change
  - (iii) evaluating performance in the remainder of the civil service

Option A: What needs to be done inside Greece (2)

Take immediate radical measures:

- Do not impose new taxes
- Collect the existing taxes
- Reduce (presently rampant) tax evasion
- Do it by creating a new tax police and tax courts that work fast
  - Similar to the creation of the FBI to deal with rampant lawlessness in the Midwest in the 1920s, because of corruption in Illinois and other States

Option A: What needs to be done inside Greece (3)

Immediate necessary measures

- New investments in infrastructure
  - From EU structural funds
  - By saving money from civil servants wages and investing businesses that create jobs

Option A: What needs to be done inside Greece (4)

Implement the many other structural changes that will have effects over time

- Liberalize the labor market
- Open the “closed” professions
- Other structural reforms

Option A: What needs to be done externally (with EU, IMF, & ECB)

- Extend the fiscal consolidation period and reduce its year-by-year intensity
- Receive the EU structural investments for infrastructure and possibly renewable energy
- Get a grace period of 3-5 years on interest of loans to the official sector
  - Without an increase of the size of the loans
  - Use the resulting €5-6 billion for investments

Option B:

- Reject lenders’ terms, and declare bankruptcy (hard, uncontrolled default), leading to the drachma and “sudden death” (rejected by voters in recent election, 7/12)
- Three political parties (SYRIZA, Independent Greeks, and Golden Dawn) have positions close to option B

Greece leaving the euro is a very bad for debt

- If Greece leaves the euro, its “new drachma” will be devalued significantly compared to the old drachma
  - Old drachma to euro approx. 340 dr = 1 €
  - New drachma to euro approx. 1000 Ndr = 1 €
- Debt is in euros, suddenly gets multiplied by 3 in new drachmas
- Outside the euro, Greece will be forced to borrow at very high interest rates
- Debt will be unsustainable (again)
- It will be hard to reduce the debt because most of it will be to EU countries and the IMF

Greece leaving the euro will create very high inflation

- Will result in very high inflation in Greece where practically everything is imported
  - Prices in Greece will be multiplied by 3, wages and pensions cannot adjust quickly, and Greeks will become much poorer
- To pay public servants salaries and pensions, Greece will print too many new drachmas, thereby creating an inflationary spiral
- Greek politicians (who have already proved to be irresponsible) will have an “easy way out” by printing drachmas
- Will create hyperinflation

Greece leaving the euro will lead to bank collapse

- If leaving the euro is anticipated, Greek banks will collapse because
  - Depositors will withdraw their euros (what little is left in banks) because they will not trust the government to convert them to new drachmas at the “right” exchange rate
  - The ECB will withdraw its lifeline of more than € 128 billion cash to Greek banks

In summary, Greece leaving the euro will result in

- Greek banks collapsing even before the new drachma is introduced
- Extreme poverty as goods become three times more expensive
- Hyperinflation as Greek politicians will now be able to print currency
- Likely social unrest
- **Greece has significant national and political reasons besides economic reasons to stay in the Eurozone at the core of the EU**
  - Danger of isolation in a neighborhood of a very aggressive enemy which can easily overpower Greece militarily
  - Greece needs the support of the EU and the US to counterbalance

Option C:

Make no significant changes, linger in the present swamp, leading to eventual bankruptcy ... (“death by thousand cuts”)

Option C: The biggest danger

- The Greek government has to act decisively now!
- Biggest danger is inertia, not acting on:
  - Cutting the expenses of the state sector
  - Implementing structural reforms

Is there hope for Greece? **Yes!**

- But things have been on a knife-edge for 3 years now
- People are tired of the uncertainty
  - Desperately need “good news”
- People are close to exhausting their savings as new taxes have been imposed when salaries were falling
- Nevertheless I am optimistic