# The Greek and EU crisis

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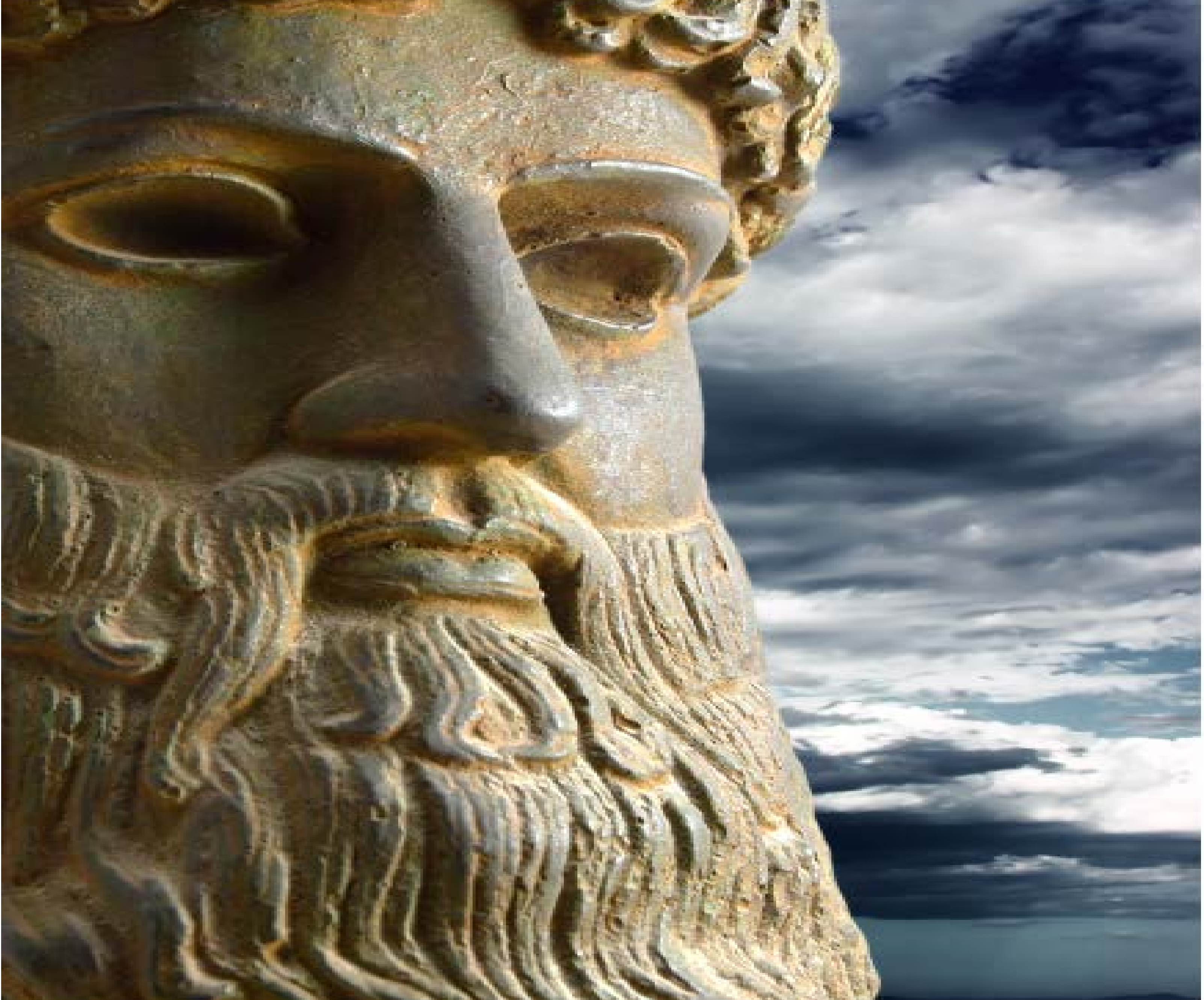
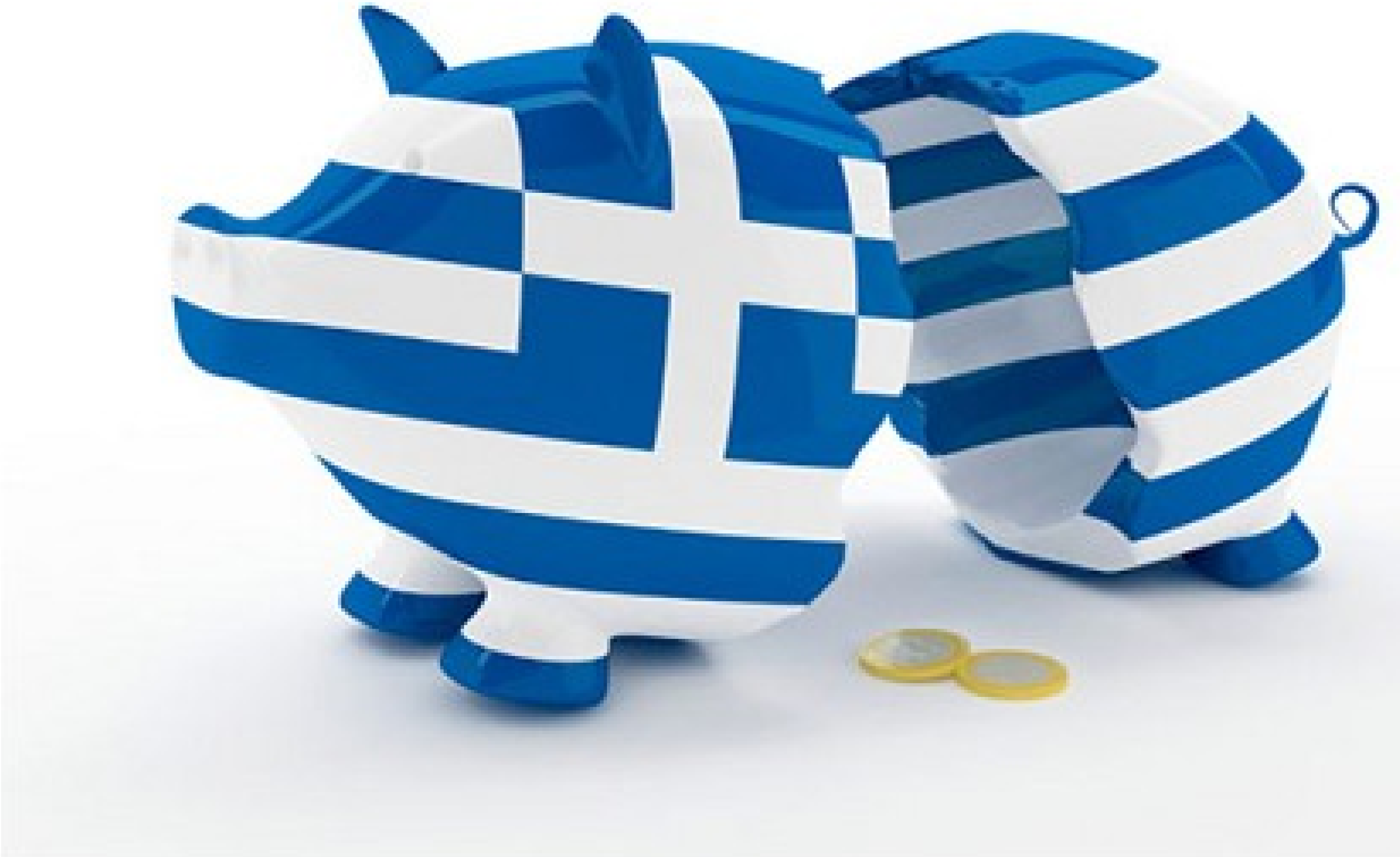
# Most of my work is on networks

- Physical networks (e.g. telecom)
- Virtual networks of complementary components
  - Operating systems and applications
  - Banks that borrow from each other
  - Credit card networks
  - Advertisers and users of search in Google
  - Financial exchanges (NYSE, NASDAQ)





# 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 the PSI (haircut)
- Lack of competitiveness caused by
  - Union power increasing wages and salaries without productivity increases
  - “Closed” sectors, including taxis, trucks, pharmacies, engineers, lawyers, notaries, ...
  - Fixed exchange rate (locked in the Euro)

# OPTIONS FOR GREECE

# Three options available to Greece (June 27, 2012)

A. Limited renegotiation of lenders’ terms, implementation of structural changes, staying in Euro

B. Rejection of lenders’ terms, and declaration of bankruptcy (hard, uncontrolled default), leading to the drachma and “sudden death” (rejected by voters)

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?**

# BACKGROUND

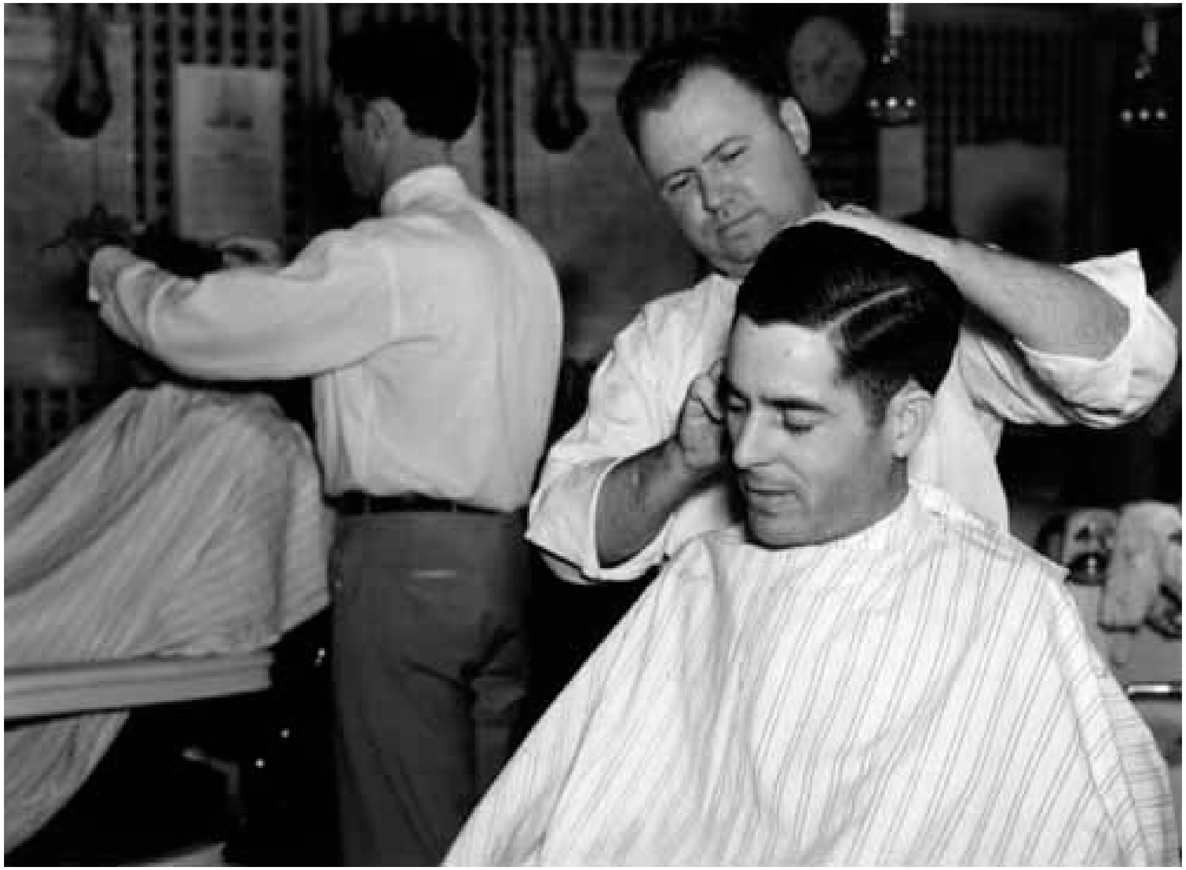
# The EU & IMF provided Greece with loans of €110b asking for reduction of public deficit and liberalization of “closed” sectors (May 2010)

- Things did not work smoothly because
  - The EU, the IMF, and Greece focused on a short run perspective, essentially postponing the full acceptance of the problem
  - Serious disagreements arose among the EU members, and between the EU and the ECB
  - Some of the imposed requirements were unfeasible
  - The Greek gov. proved inept in implementing the agreements and did not do many of the agreed reforms
- The Greek gov. essentially gave its power to the EU/IMF/ECB lenders; did not distinguish between feasible and unfeasible demands
  - Almost every economic measure adopted so far was dictated by the EU/IMF/ECB lenders
- This, combined with a deep recession and high unemployment has created a very negative mood in Greece

# Greek sovereign debt large and growing

- Greek sovereign debt: €329 billion at end of 2010, €368 billion at end of 2011
- In May 2010, EU & IMF promised Greece a €110 billion loan (EU €80b; IMF €30b)
- Greek GDP was €227 billion in 2010; €215 in 2011
- Greek sovereign debt was 145% of GDP at the end of 2010; 165% of GDP at end of 2011
- Greek debt growing because:
  - Despite cuts in public sector expenses, the Greek public sector had a budget deficit of 10.6% in 2010 (9.1% in 2011), which increased debt
  - Severe recession in Greece reduces the GDP and therefore increases Greek sovereign debt as a percentage of GDP

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



# Economides-Smith (2010) proposed a fully voluntary restructuring of Greek debt

- using the Brady method
  - Would have had no default and no “credit event”
- Instead, Greece used a compulsory restructuring (after a voluntary one) resulting in
  - Controlled bankruptcy
  - “Credit event”
- Still there were substantial benefits
  - 74% haircut
  - Obligations moved to long term
- But, because the haircut was imposed in 2012 and not 2010, most Greek obligations have moved to the official sector
  - Reducing the size of the restructured amount
  - Official sector obligations will be harder to restructure in the future

# Substantial problems for Greek banks after the PSI

- Greek banks had about €50 billion exposure to Greek sovereign bonds
- They took a large accounting hit at the PSI
- These losses had already occurred, but banks did not show the losses in their books
- Restructuring implied an accounting recognition of the existing losses
- Greek banks need to recapitalize
  - Temporary recapitalization
  - Final recapitalization terms not determined
  - Crucial that banks do not become part of the Greek State bureaucracy

# Option A: Limited renegotiation of lenders’ terms, implement structural changes, stay in Euro

# Option A: What needs to be done Internally (1)

**Take immediate radical measures:**

- Reduce the public sector
  - Cut the general (non-wage) expenses of the state; change procurement process
  - 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 Internally (2)

**Take immediate radical measures:**

- Collect the existing taxes
- Reduce (presently rampant) tax evasion
- Do not impose new taxes

# Option A: What needs to be done Internally (3)

**Immediate measures**

- New investments in infrastructure
  - From EU structural funds
  - From saving €6 billion by postponing interest payments to the official sector

# Option A: What needs to be done Internally (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)

# Should Greece do a hard default / uncontrolled bankruptcy?

- Lehman-like (2008) event with adverse effects for world financial markets
- Bad for Greece, the EU, and the US
- Under a hard default, Greece will
  - have to balance its public sector immediately
  - have to cut public sector procurement and lay off about 20-25% of civil servants immediately
  - Greek importers will have to pay cash
  - Huge disruption of trade; will be difficult to find imported goods, even necessities like drugs and fuel
  - Exclusion of Greece from capital markets for years
- Greek banks likely to collapse
- EU banks will face additional large losses
- “Credit event” will trigger CDS and have repercussions in many markets, including in the US

# 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 cut 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 huge 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

- As 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 the 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 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 new Greek government has to act decisively now!
- Biggest danger is not acting on:
  - Cutting the expenses of the state sector
  - Liberalizing the labor market

# Is there hope for Greece? Yes!

# The Euro experiment

- Euro created without a fiscal and political union
- EU thought it had decades to make a fiscal and political union
- 2008 crisis showed the weaknesses of a common currency without a fiscal and political union

# Many bailouts – weak firewall

- Greece, Ireland, Portugal, Spain, Cyprus receiving bailouts (5 out of 17) and more may be added
- Weak firewall
- ESM/EFSF are very small for the size of the problem, unable to deal with large bailouts
  - Need to be 5-10 times larger

# Bank deposits guarantee

- Need Eurozone-wide deposits guarantee by the ECB
- Difficulties because of variance in bank charters

# EU debt issues

- Sovereign debt was recycled to banks and financed by low interest 3-year loans of the ECB
  - Not a good solution
  - Temporary
  - Financial markets target the weakest sovereign bond
- Need pooling of risks and closer supervision of budgets to minimize moral hazard

# Eurobonds

- Very likely to happen within a year
- Short or long maturities?
- What percentage of the country’s debt would they cover?
  - 10% of GDP? 30%? Any amount of debt over 60% of GDP?
- Extent of financial supervision by Brussels

See “Greek economists for reform” at http://greekeconomistsforreform.com/ for a discussion by prominent Greek academic economists on the crisis