



The Greek and EU Crisis for non-economists

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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 month 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 11 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/manufacturing 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 (Greek companies have 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

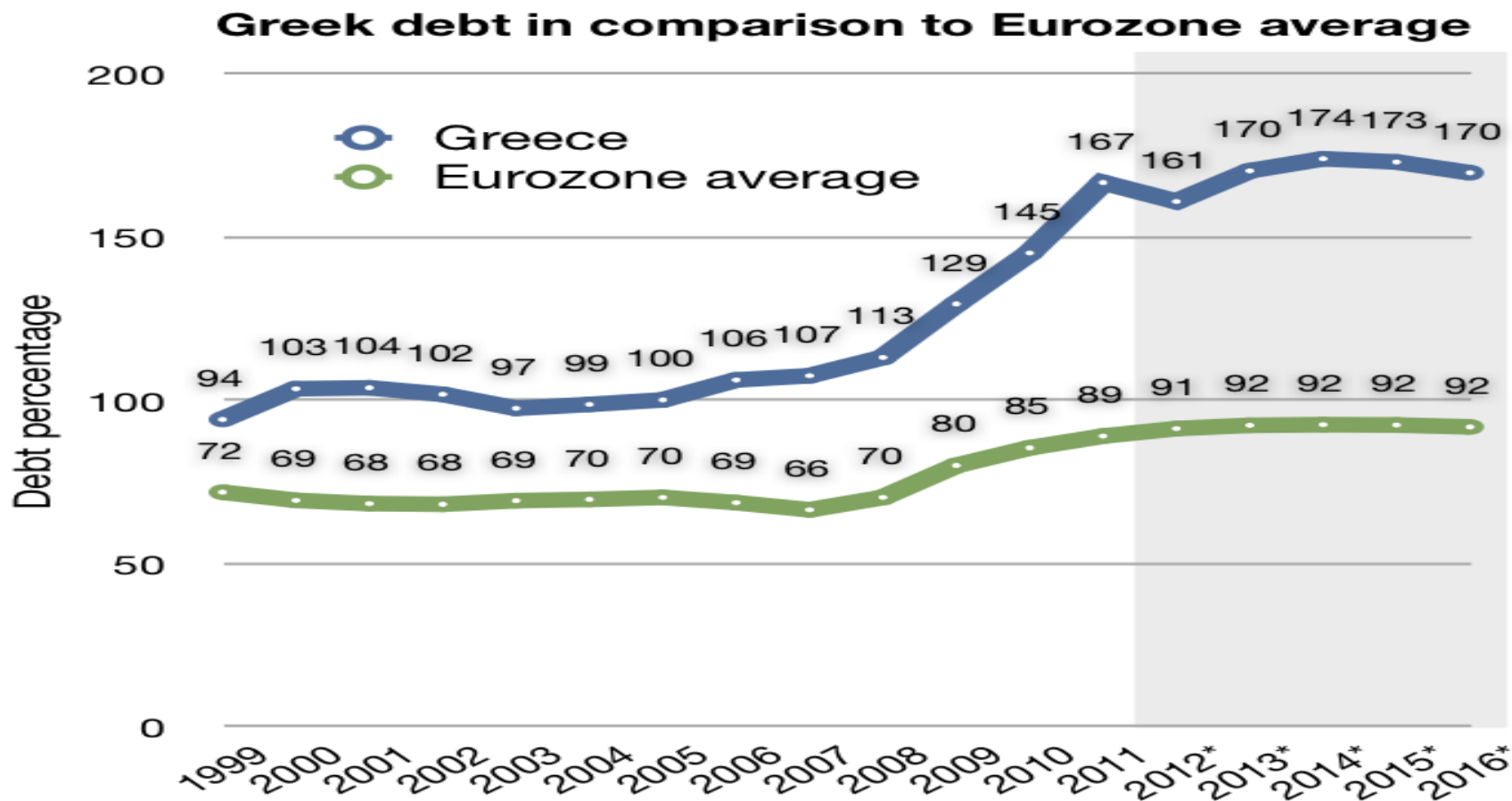


Greece is bankrupt since 2009

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



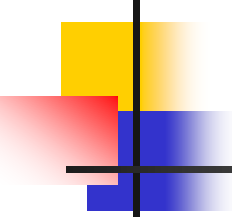
Where did/does the money go?

1. State spending; because of corruption and patronage

- Very excessive number of civil servants (800,000 in a country of 11 mil), salaries and pensions are 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 to the tax collector (under the table)
 - State collects only 20% of the total tax obligation



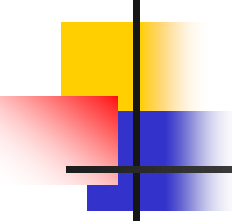
Dealing with the crisis: “Mnemonia” Memos of understanding between the creditors (EU, IMF, ECB) and Greece

- 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



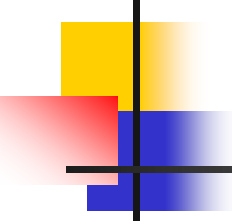
Three options available (March, 2013)

- 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?**



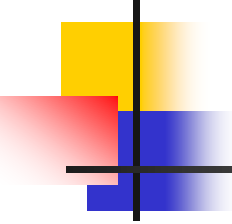
Option A: Implement structural changes, stay in Euro



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

Take immediate radical measures:

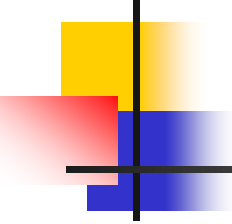
- Reduce the public sector
 - Cut the general (non-wage) expenses of the state; change procurement processes
 - Reduce the number of civil servants over and above the natural attrition of 5% by
 - (i) closing useless divisions
 - (ii) eliminating jobs that have been surpassed by technological change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



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

Take immediate radical measures:

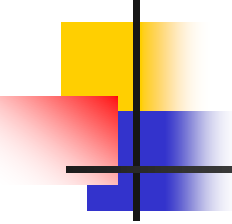
- Do not impose new taxes
- Collect the existing taxes
- Reduce (presently rampant) tax evasion
- Do it by creating a new tax police and tax courts that work fast
 - Similar to the creation of the FBI to deal with rampant lawlessness in the Midwest in the 1920s, because of corruption in Illinois and 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 in the parliament (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. $340 \text{ dr} = 1 \text{ €}$
 - New drachma to euro approx. $1000 \text{ Ndr} = 1 \text{ €}$
- 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 very 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 and businesses 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



Cyprus banking crisis

- Cyprus has a large financial system compared to the rest of its economy
 - Ratio of banking assets to GDP in Cyprus larger than Malta but much smaller than Luxemburg
 - Allegations of money laundering by Russians
- Causes of the Cypriot bank crisis
 - Haircut on Greek bonds held by Cypriot banks
 - Non-performing loans in Greece and Cyprus



Cyprus needed at least €15.5 bil support; EU gave only €10

- 3/15/13 deal imposed on all banks:
 - 7.5% haircut on deposits below €100,000
 - 9.9% haircut on deposits above €100,000
- Rejected by Cypriot parliament
- New deal
 - ESM/EFSF funds were not used, even though these funds were created for that purpose!
 - Cypriot banks sold subsidiaries in Greece to Piraeus Bank
 - No haircut on deposits below €100,000
 - Close Laiki Bank with losses of 80% on deposits over €100,000
 - Restructure Kyprou Bank with losses of 40% on deposits over €100,000
- Cyprus will decline as a financial center



EU officials now say that deposits in Europe not untouchable

- Dijsselbloem (new Eurogroup president): “Cyprus Deal Is A New Template,” 3/25/13 Financial Times Interview
- Rehn (EU's economics commissioner): “If a bank fails, depositors with over €100,000 can take a hit,” 4/6/13, Reuters & Finnish TV
- In contrast, in the US, FDIC insures deposits to \$250,000 and the Fed has not imposed a haircut on any large depositors of failing banks for the last 50 years
- The (new) position of the EU on banking will lead to a bank run out of Southern European banks towards Germany, UK, and US
- This is a disastrous position for the EU taken only to support Merkel's coalition in upcoming elections

