Greek and EU Economic Crisis
ΚΕΠΕ, May 28, 2014

Prof. Nicholas Economides
Stern School of Business, New York University
& Haas School of Business, UC Berkeley
http://www.stern.nyu.edu/networks/
NET Institute **http://www.NETinst.org/**
mailto:**economides@stern.nyu.edu**

The European Union

- is an attempt to avoid endless wars that historically have plagued Europe; enhance close cooperation; become a powerful union countering the US and China
  - Started as a customs union (τελωνειακη ένωση); added movement of capital and labor
  - Laws coordination (progressing, incomplete)
  - European parliament (limited but increasing powers)
  - Euro (common currency)
  - Political union (long run objective)
  - Common taxation (long run objective)
  - Issue mutual obligation bonds – Eurobonds (long term)

Obstacles to integration

- Different languages
- Different traditions
- Varying productivity but same currency
  - Therefore, to avoid imbalances, it has to rely
    - Internal equalization of productivity
    - External movement of capital and labor
- Lack of common taxation
- Lack of ability to do monetary transfers/gifts across nations
  - In contrast, transfers are done implicitly among US States
- Limitations of the Charter of the European Central Bank
  - Fed.'s balance sheet has $2.3 tr. bonds and 1.6 tr. mortgage based securities; ECB could not buy anything like that

Unification is not easy

- Long civil war in US to define property rights and rights of States v. Federal Government
- Other unified countries have splintered (Yugoslavia, Ukraine)
- Cyprus has been invaded and occupied by Turkey for 40 years

Economic crisis

- The 2008 world-wide economic crisis that followed the collapse of *Lehman Brothers* underscored
  - Weaknesses of European economic and political integration processes
  - Significant differences in the strength of the economies of the member States
  - Lack of preparation for a crisis
  - Lack of institutions to deal with a crisis

The crisis manifested mainly in three areas

- In Greece, Ireland, Portugal, Spain, and Cyprus the crisis manifested mainly as a debt and public spending crisis
  - In Greece, additional problem of low productivity and need for structural reforms
- In these countries, as well as a number of Northern European countries, there was a compounding crisis of the banking system
- The crisis underlined the lack of flexibility of economies of varying strengths tied to the same currency, the Euro

“On the ground,” the EU dealt with the crisis by

I. imposing conditions on Greece, Portugal, Ireland, Spain and Cyprus
   - Reducing their budget deficit (increasing taxes, reducing spending)
   - Increasing competitiveness by opening markets to competition and other “structural reforms”
   - Recapitalizing their banks
   - Facilitating reductions in privately held sovereign debt (Greece) – PSI (“Private Sector Involvement”), “haircut”
   - Possibly reducing the obligations of program countries to the EU and its institutions (not done yet)

Conditions were implemented through a "Troika" of representatives of EU, IMF and ECB, based on an IMF macro model

- Implementation was mired by
  - Significant differences of opinion among the three parties
    - Ex., strictness of IMF lending rules and ratio of debt to GDP vs the EUs
  - Significant errors in the predictions of the IMF model for these countries
    - the IMF model predicted Greek recovery in 2011, 2012, and 2013, which happened only in 2014

Implementation was also mired by

- Often imposing unfeasible objectives in the specified timeframe
  - There is no doubt that the targets of the first memo with Greece were unfeasible
  - Sometimes asking for changes that most OECD countries do no follow
    - Example: taxicabs in Athens vs. New York
- Often not prioritizing (by importance and by timing) the objectives and conditions imposed

At the macro level, the EU dealt with the crisis by

II. Creating the EFSF, EFSM, and ESM rescue mechanisms, besides the IMF's

- EFSF (European Financial Stability Facility, May 2010) €440 later €780 bil
- EFSM (European Financial Stability Mechanism, May 2010) €60 bil
- ESM (European Stability Mechanism, Oct 2012) €500 bil

EU programs

- Lent at very low interest rates
  - Current program rate for Greece is 1.82%

Disbursement of funds

(in € bil) (GLF: Greek Loan Facility)

	Greece	Portugal	Ireland	Spain	Cyprus	Total Use	Total Ability
EFSF/ EFSM/ GLF	144.6 52.9	52	40.2			236.8 52.9	740
ESM				41.4	9	50.4	500

At the macro level, the EU also

III. Rescued banks

- Through lending to a state that then lends to the bank
  - Financial stability loans for recapitalization of banks appear as state loans (€48-50 bil. in the case of Greece) – does not make sense
  - Gives primacy to state and fractures the banking system

Uniform rules are lacking and rules are changed on occasion

- EU set new banking rules, but these rules are adverse to the unification of the EU banking system
- For example, in the Cyprus banking crisis, the EU did <u>not</u> use the ESM/EFSF funds set up for this purpose but
  - Imposed a haircut on depositors
  - As a result, it degraded the quality of Cypriot banks

The EU banking rules during the crisis

- Reduced the quality of EU banks compared to US banks
  - By declaring that large bank deposits in Europe can be subject to haircuts
- In contrast, in the US, FDIC insures 100% deposits to $250,000 per person per bank and has not imposed a haircut on any small or large depositor of a failing bank since WWII

Only last month, under the Greek presidency

- The Single Resolution (Bank) Mechanism (SRM) was passed
- Broke the link between banks and sovereigns
  - Now the ESM can directly recapitalize banks!
  - But Greek banks recapitalized under "old regime"
- Established a clear pecking order on bank losses: shareholders; bondholders; large depositors
  - Insurance for deposits up to €100,000
- Provide "fiscal backstop" to periphery banks (although unclear where the money for the fiscal backstop will be found)

Worse points in the crisis

- January 2010 when it became clear that Greece was bankrupt and had a 15% budget deficit
- November 2011 when George Papandreou considered a referendum
- May-June 2012 when there was significant political risk that Greek election results would precipitate Greece leaving the Euro with unknown consequences

After six years of crisis, the acuteness of the debt and public spending crisis has passed and recovery is very close

- Ireland recovered and left the program; Portugal is close to leaving
- Greece that had the highest budget deficit
  - now has a primary surplus (gov. budget surplus disregarding interest)
  - is participating again in international money markets (issued a new bond in April 2014)
  - But Greece has a very large debt as a percentage of the GDP, and needs further debt relief
  - EU countries seem reluctant to proceed to Greek debt reductions

On growth

- there are many hopeful signs that the Greece, Portugal, and Ireland are recovering and there are very strong indications that the deep recession in Southern Europe is over

Historical Growth (Eurostat)

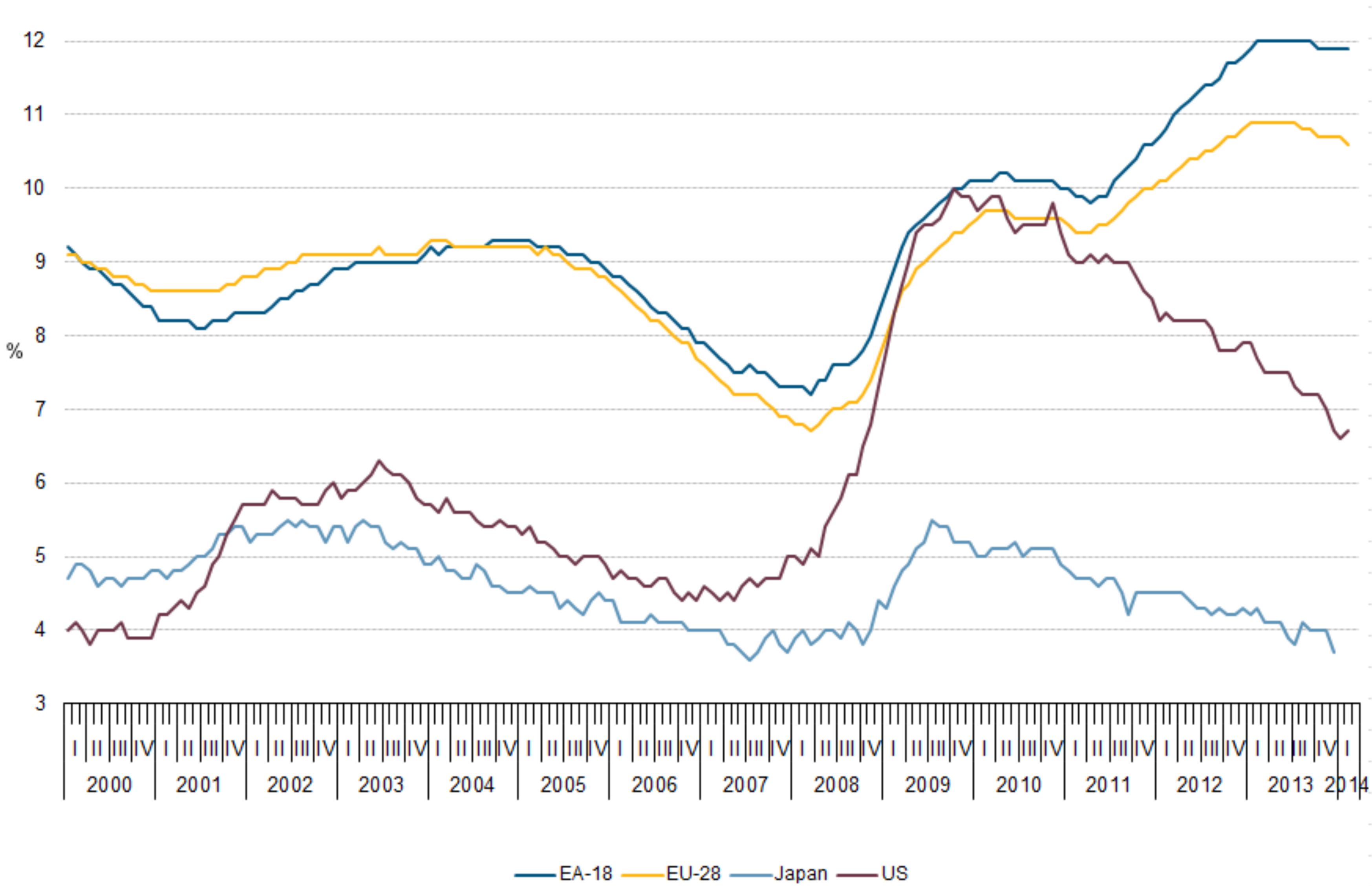
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average 2002-11
EU-27	1.3	1.5	2.5	2.1	3.3	3.2	0.3	-4.3	2.0	1.6	1.4
Euro area	0.9	0.7	2.2	1.7	3.3	3.0	0.4	-4.4	2.0	1.5	1.1
Belgium	1.4	0.8	3.3	1.8	2.7	2.9	1.0	-2.8	2.4	1.8	1.5
Bulgaria	4.7	5.5	6.8	6.4	6.5	6.5	6.2	-5.5	0.4	1.7	3.9
Czech Republic	2.2	3.8	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.7	3.3
Denmark	0.5	0.4	2.3	2.5	3.4	1.6	-0.8	-5.8	1.3	0.8	0.6
Germany	0.0	-0.4	1.2	0.7	3.7	3.3	1.1	-5.1	4.2	3.0	1.2
Estonia	6.6	7.8	6.3	8.9	10.1	7.5	-3.7	-14.3	2.3	7.6	3.9
Ireland	5.9	4.2	4.5	5.3	5.3	5.2	-3.0	-7.0	-0.4	0.7	2.1
Greece (1)	*3.4*	*5.9*	*4.4*	*2.3*	*5.5*	*3.0*	*-0.2*	*-3.3*	*-3.5*	*-6.9*	*1.1*
Spain	2.7	3.1	3.3	3.6	4.1	3.5	0.9	-3.7	-0.1	0.7	1.8
France	0.9	0.9	2.5	1.8	2.5	2.3	-0.1	-3.2	1.7	1.7	1.1
Italy	0.5	-0.1	1.7	0.9	2.2	1.7	-1.2	-5.5	1.8	0.4	0.3
Cyprus	2.1	1.9	4.2	3.9	4.1	5.1	3.6	-1.9	1.1	0.5	2.5
Latvia (2)	7.2	7.6	8.9	10.1	11.2	9.6	-3.3	-17.7	-0.3	5.5	3.9
Lithuania	6.8	10.3	7.4	7.8	7.8	9.8	2.9	-14.8	1.4	5.9	4.5
Luxembourg	4.1	1.6	4.4	5.4	5.0	6.6	0.8	-5.3	2.7	1.6	2.7
Hungary	4.5	3.9	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.7	1.8
Malta	2.8	0.1	-0.5	3.7	3.1	4.5	4.1	-2.6	2.5	2.1	2.0
Netherlands	0.1	0.3	2.2	2.1	3.4	3.9	1.8	-3.7	1.6	1.0	1.3
Austria	1.7	0.9	2.6	2.4	3.7	3.7	1.4	-3.8	2.1	2.7	1.7
Poland	1.4	3.9	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3	4.2
Portugal	0.8	-0.9	1.6	0.8	1.5	2.4	0.0	-2.9	1.4	-1.7	0.3
Romania	5.1	5.2	8.5	4.2	7.9	6.3	7.4	-6.6	-1.7	2.5	3.9
Slovenia	3.8	2.9	4.4	4.0	5.9	6.9	3.6	-8.0	1.4	-0.2	2.5
Slovakia	4.6	4.8	5.1	6.7	8.4	10.5	5.8	-4.9	4.2	3.4	4.8
Finland	1.8	2.0	4.1	2.9	4.4	5.3	0.3	-8.5	3.3	2.7	1.8
Sweden	2.5	2.3	4.2	3.2	4.3	3.3	-0.6	-5.0	6.2	3.9	2.4
United Kingdom	2.4	3.8	2.9	2.8	2.6	3.6	-1.0	-4.0	1.8	0.8	1.6
Iceland	0.1	2.4	7.8	7.2	4.7	6.0	1.3	-6.8	-4.0	3.1	2.2
Norway	1.5	1.0	4.0	2.6	2.5	2.7	0.0	-1.7	0.7	1.5	1.5
Switzerland	0.2	0.0	2.4	2.7	3.8	3.9	2.2	-1.9	3.0	2.1	1.8
Montenegro	1.9	2.5	4.4	4.2	8.6	10.7	6.9	-5.7	2.5	3.2	3.9
Croatia	4.9	5.4	4.1	4.3	4.9	5.1	2.1	-7.0	-1.4	*0.0*	*2.2*
FYR of Macedonia	0.9	2.8	4.6	4.4	5.0	6.2	5.0	-0.9	2.9	*3.0*	*3.4*
Turkey	6.2	5.3	9.4	8.4	6.9	4.7	0.7	-4.8	9.0	8.5	*5.4*
Japan	0.3	1.7	2.4	1.3	1.7	2.2	-1.0	-5.5	4.5	-0.8	0.7
United States	1.8	2.5	3.5	3.1	2.7	1.9	-0.3	-3.1	2.4	1.8	1.6

(1) 2005, break in series.

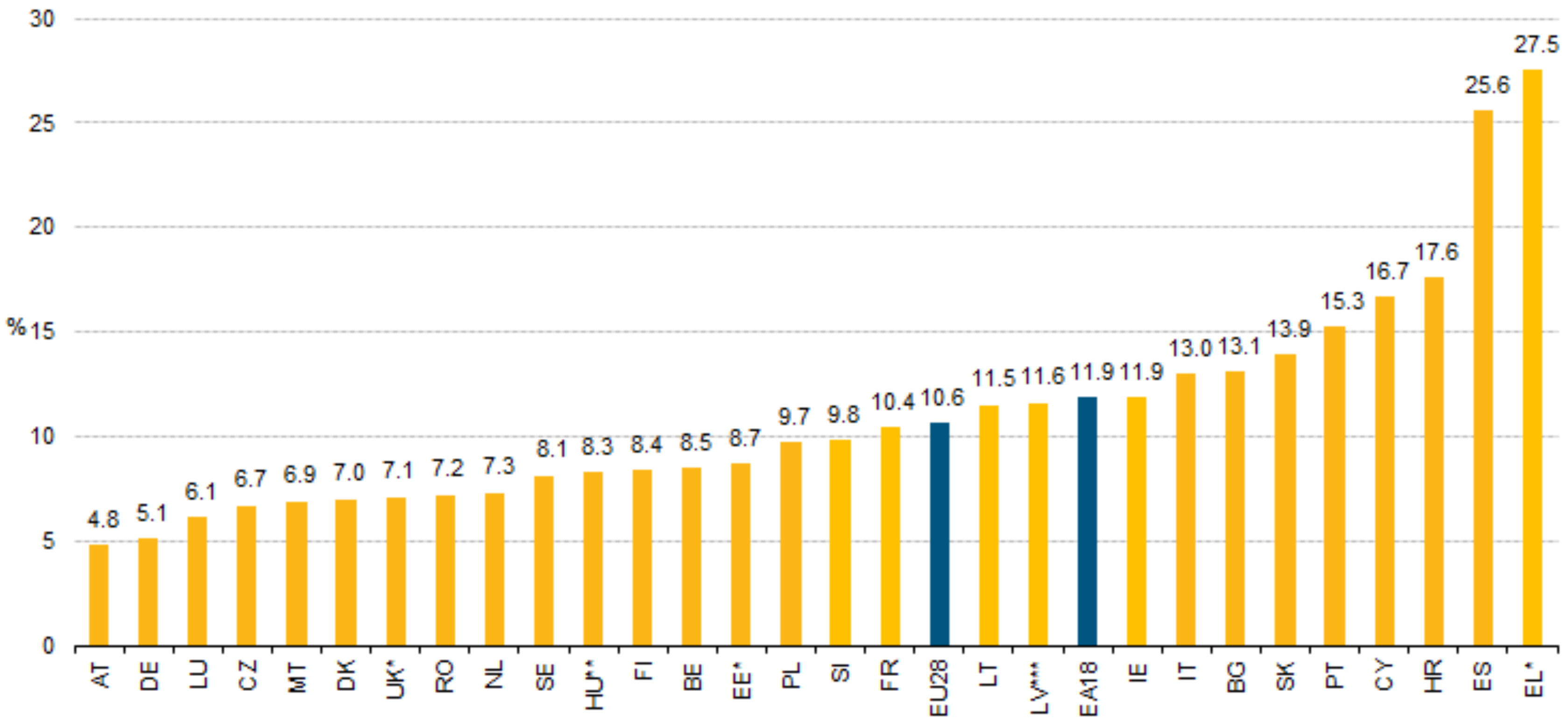
(2) Annual breaks in series.

Source: Eurostat (online data codes: nama_gdp_k or tsieb020)

However, unemployment is high
(Eurostat)

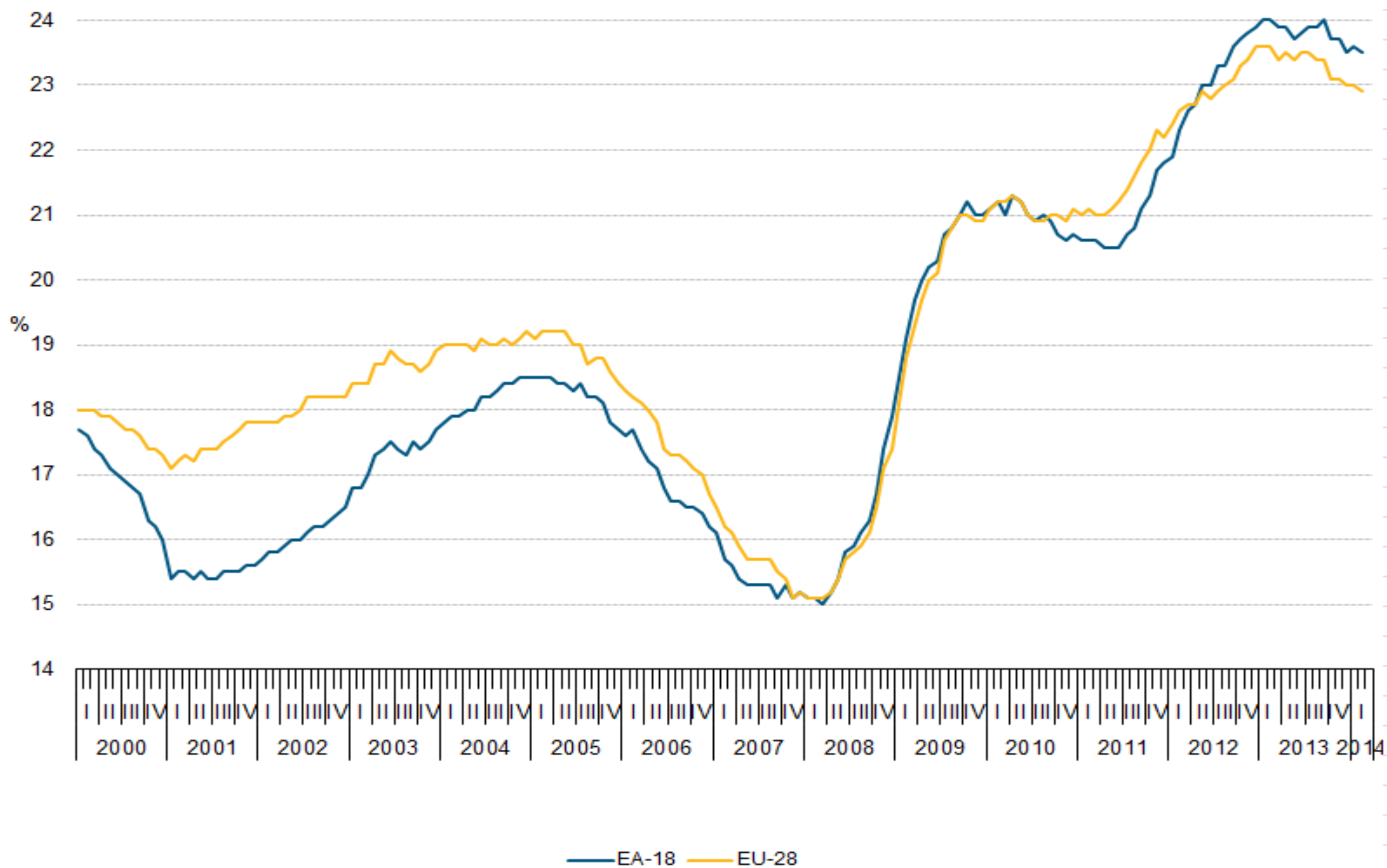


Unemployment by country (Eurostat)



* December 2013 ** January 2014 *** Q4 2013

Very high youth unemployment



Immediate tasks are clear

- Increase growth EU wide
  - Likely monetary easing measures by the ECB
- Reduce unemployment EU wide
  - Greece, Spain, Portugal need investment to reduce unemployment

Greece was the worst case, but is recovering

- Huge budget deficit (15% in 2009)
  - Now a primary surplus
- Low productivity
  - Labor market reforms, successful
  - Structural reforms, delayed, continuing
- Very high sovereign debt
  - PSI; need further reduction (OSI)
- Recovery is signaled by new bond issue
  - After 4-year exile, Greece re-entered the world financial markets in April 2014 with a 5-year bond issue with 4.75% coupon

What needs to be done in Greece (1)

- Structural reforms
  - Open closed professions
  - Allow private universities
  - Simplify state procedures for private businesses
  - Cutting tax rates
  - Reforming tax collection mechanism and reducing tax evasion
  - Creating tax courts that decide in 6 months
  - Give a zero tax period for new businesses for 5 years

Total Greek Debt	321.8
Official Sector	250.5
Private Sector	71.3

	Years to maturity	**Private**	**Official**	**Total**
Short	**y < 3**	17.8	28.5*	**46.3**
Medium	**3 < y < 13**	16.8	29.2**	**46**
Med-long	**13 < y < 19**	36.7	52.9***	**89.6**
Long	**19 < y < 25**	0.0	139.9****	**139.9**
Very long	**> 25**	0.0	0.0	**0.0**
Total		**71.3**	**250.5**	**321.8**

* IMF; **ECB loans; ***EU bilateral (country to country) loans

**** EFSF loans

What needs to be done in Greece (2)

- OSI (Official Sector Haircut)

1. No direct haircut (politically unfeasible)
2. Move debt maturity to 75 years
    - 52.9bil 18-year bilateral loans to 75 years
    - 139.9bil 24-year EFSF loans to 75 years
    - Possibly the 29 bil 4-year loans of the ECB
3. Reduce rates to *fixed* interest rate 1%
4. Defer (postpone) interest payments for 5 years
5. Invest the saved €5-6bil interest per year (2-3% of GDP)
6. Eventually (after 5-10 years) issue new bonds and pay off debt to the EU countries and EFSF at discount
7. This process will save Greece at least 50% of its Official Sector debt obligations in terms of present value

New investment in Greece

- Objective: to reduce unemployment from 25% to 15% in two years
- Sectors
  - Tourism
  - Renewable energy
  - Infrastructure
  - Export industries
  - Specialized agriculture

Assessment of EU after crisis

- In many ways, the EU got more unified in dealing with the crisis
- Was able to deal with an acute crisis through collective action
- Built rescue mechanisms
- Attempted to (and is in the process to) unify banks’ regulation

In other ways the EU fumbled

- Often it did not implement EU-wide solutions
- Created ad-hoc rules on a case-by-case basis
  - Spanish banks were treated better than Greek banks
  - Greek banks were treated better than Cypriot banks

Overall the EU came out stronger from the crisis

- But it needs to build institutions during non-crisis times
  - Uniform banking rules
  - Rules on use of ESM, EFSF
  - Eventual EU-wide taxation and creation of mutual bonds (Eurobonds)
  - Strengthening of the European parliament