"Greece & Europe: Beyond the Financial Crisis"

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by

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SUMMARY

Ladies and gentlemen, today's lecture addresses two main questions:

1) **Will the Euro Area survive the next economic crisis?**
2) **Will Greece be a member of the Euro Area over the next decade?**

The two questions are interrelated, as the Greek crisis has laid bare the faults in the architecture of the Euro Area and forced policy makers to address some of those faults. Yet political development in Greece have postponed the complete resolution of the Greek crisis, hence the nature of a future policy response to the continuing Greek crisis will continue influencing the politics of the evolving Euro Area architecture. The conditions under which Greece would be allowed to continue participating in EMU has implications on EMU stability. I will not be surprised, for example, if the conflict that took place between Greece and the Euro Area over the last few months does not end up influencing a European view that is essential from now on to incorporate into the EMU bylaws the risk of a country departure from EMU. Such a risk would be viewed as a force of stability.

Addressing the first question on the survival of EMU, although I share the concerns of my American colleagues that the Euro Area is not an "Optimum Currency Area," I tend to be more optimistic than them. This optimism is also based on experience. During the last few years, European policy makers, although sluggish in their response to the Greek & EMU crisis, have shown willingness to both contain the crisis and – belatedly - fill in the missing elements in the architecture of the monetary union, even at the cost of prolonging the crisis.

As a result of the Greek economic crisis, we witnessed not only a huge loan to Greece aimed at reducing the negative domestic consequences of the crisis, but also the establishment of the European Stability Mechanism and the push for a closer Banking Union, which is soon to become fully fledged. The recent five-Presidents Report of June 2015 contains an overview of the European aspirations for an even closer monetary union in economics and in politics. EMU today is a more stable

union than six years ago and its policy makers are discussing options of further strengthening that stability. Thus, as a European, I see the monetary union cup half-full, not half-empty. EMU can become an optimum currency area if reforms bring convergence in the structure of the individual EMU economies. Once this convergence is achieved, it would be politically more feasible to also create an effective fiscal transfer mechanism.

I will now spend more time in addressing the second question on the continuity of Greek membership in EMU. Following the crisis climax of this past summer of 2015, when Greece flirted with exit but chose to accept the terms of the lenders and remain in the Euro Area, there is a general belief – even complacency – among policy makers and market participants that the worst risks are behind us.

Indeed, despite many popular myths in the international media about how bad the Greek economy operates or even how lazy Greek people are, who live off the money of their European partners and do not pay their taxes, how Greece cheated on its statistics to enter EMU, or how Greeks refrain from any structural reforms, etc., the reality is very different. Greece entered EMU with correct statistics, which were subsequently revised due to an ex-post exogenous accounting change. According to the OECD, Greeks are the hardest working Europeans in EU-28, and Greece is the number one country in new reforms for three years in a row since 2011. By the end of 2014, most risks were behind us. In 2015 some risks were reignited but this should not confuse us from the fact that Greece had already made enormous progress to address most of its fundamental economic imbalances, by correcting its fiscal and current account deficits and its wage competitiveness vis-a-vis the rest of Europe.

Following an unprecedented 26% contraction in real GDP, the Greek economy stabilized and grew by 0.7% in 2014, with unemployment finally reversing its earlier upward trend. Throughout 2014 economic sentiment was rising, banks were recapitalized with private sector money, privatizations began unrolling, wage competitiveness was restored, and the change in investment was positive for the first time in six years. The economy was ready for a major take-off, with an expected growth rate higher than 2.5% in the years 2015 and beyond. Even the debt-to-GDP ratio was on a sustainable path thanks to the positive growth outlook, to the small interest rate burden charged by EMU lenders, to the long maturities of the loans and to the country's renewed ability to generate primary surpluses. Most risks were thus behind us. The requirements of the second MoU, which were signed back in 2012, were about to be completely satisfied and a new Extended Conditions Credit Line was in place for 2015 and beyond, which would have smoothed the return of Greece to normal market borrowing conditions.

Then in January 2015, the onset of a new and untested left wing government led to a (five years too late) clash with the lenders, which generated a lot of uncertainty and destroyed credibility, thus putting a stop to the earlier upward momentum. Households began pulling their deposits out of the banks – just as they had done four years earlier - and market activity more or less froze. The government was reluctant to finish up with the last few requirements of the second MoU and, deprived of cash it simply accumulated new arrears and stopped public investment projects, thus further pressuring the private sector to stagnation.

Meanwhile stock prices collapsed and the value of government ownership in banks from around 24 billion euro in 2014 was just above two billion! Even worse, new capital needs arose as bank non-performing loans began rising again. A new and unnecessary Greek crisis had flared up and was followed by the imposition of a bank holiday and capital controls in late June, which now threaten to prolong a new recession well into 2016.

After an agonizing political process over the summer, which even included a Greek referendum of ambiguous content, the Greek government eventually signed a new third MoU in August, which provides for guaranteed financing over the next three years of up to 86 billion euro. The MoU is accompanied by a set of requirements to further reform the public sector, the pension system, the system of taxation, the operation of markets, licensing requirements, etc.

Most of those reforms would be beneficial to future growth. Yet, it is unclear how forthcoming the Greek government would be in delivering the reforms it signed and on time. In the past, while in opposition, it had opposed most of them and during the first six months of 2015, as a government it essentially avoided addressing any of those issues. The new coalition government that was formed after the national elections of September 20, 2015, is similar to the previous one, with very few new faces.

So, coming back to the original question I posed in the beginning of my speech, should we view the recession of 2015-16 as a temporary two-year delay of an inevitable economic take off later on, or as the beginning of a long period of stagnation that may even lead to exit from EMU and a further collapse of living standards? Will Greece continue to be a member of EMU? It is difficult to assign probabilities to those scenarios.

Thus far, the lenders have shown some flexibility in reducing the earlier targets on the size of the current and future primary fiscal surpluses, recognizing the negative effects of the on-going recession on budget revenues. They seem less flexible in immediately reducing the present value (via maturity extensions, postponement of interest payments, etc.) of Greek government debt. It seems the lenders would like

to hold the issue of debt relief as leverage in order to keep pushing the Greek government to reform. I would not be surprised if they even came up with a formula of attaching present value debt relief to the delivery and sustainability of specific reforms.

On the Greek side, it remains to be seen whether the government will show an equivalent flexibility and open mindedness in reforming the country and eliminating waste in a way that promotes growth, thus gaining credibility and present-value debt relief. For this to happen, it is essential that reforms are finally understood by policy makers and the population as vehicles of deeper democracy and more power to the people. We are not there yet.

So far the government has failed to present a specific long-term growth plan and its policy is very short-term oriented, relying too heavily on new taxes instead of expenditure reduction. Obviously, the emphasis on taxation does not bear well with future growth. Moreover, unless it quickly recapitalizes the banking system and makes the country attractive to new investment opportunities, the scenario of positive growth after 2016 would soon become a distant dream. The horror of Grexit would resurface.

It is clear that the economic trajectory of the country over the next decade depends critically on the evolution of domestic politics.

Thank you for your attention.