

The Greek Financial Crisis

A Panel Discussion held in Athens among distinguished central bankers and academics

On Friday night, 24/9/2010, at the end of a two-day academic conference on "Household Finance," organized by professors **L. Guiso, M. Haliassos, G. Hardouvelis, and T. Jappelli** under the auspices of the Frankfurt-based Center of Financial Studies, Greek Minister of Finance, Mr. **George Papakonstantinou**, addressed the audience and made some key remarks on the Greek economy.

A panel discussion also took place on the Greek financial crisis. The chair of the discussion was the conference main co-organizer **Michael Haliassos**, Professor at Goethe University in Frankfurt. Speakers in order of appearance were: (a) **Lucas Papademos**, Professor at Athens University and Former Vice President of the European Central Bank; (b) Athanasios Orphanides, Governor of the Central Bank of Cyprus; (c) **Gikas Hardouvelis**, Professor at the University of Piraeus and Chief Economist at Eurobank; (d) **Christos Gortsos**, Professor at Panteion University and Secretary General of the Hellenic Bank Association; and (e) **Costas Meghir**, Professor at Yale University, together with **Dimitris Vayanos**, Professor at the London School of Economics.

In his presentation Mr. **Papademos** addressed four issues: *First*, placing the Greek financial crisis in a broader context, he examined the fiscal consequences of the financial crisis in advanced economies, their implications for the economic and financial outlook, and the challenges they pose for economic policy.

Second, he considered the main causes of and other contributing factors that account for the severity of the fiscal and economic crisis in Greece. He identified six fundamental sources of vulnerability relating to economic, structural and political factors, as well as three other determinants relating to financial market features, concerns and expectations.

Third, he assessed the policies that have been pursued so far and the prevailing financial market conditions, focusing in particular on the reasons financial markets do not seem to be convinced about the effectiveness of the economic adjustment program.

Fourth, he highlighted the main policy challenges that lie ahead and the essential conditions for the achievement of the set objectives. He emphasized the need not only to address the root-causes of the fiscal imbalances and structural weaknesses, but also to achieve positive synergies between fiscal consolidation measures and growth-enhancing policies, by implementing reforms to restore the country's competitiveness and improve its economic growth potential and employment prospects.

In his presentation, Mr. **Orphanides** concentrated on the economic governance in the euro area and the lessons that can be drawn from the Greek crisis about reforming it. The recent sovereign crisis is an

opportunity to correct existing shortcomings in the required budgetary discipline of member states within the Euro Area and thus reinforce macroeconomic stability in the monetary union. This is something the Van Rompuy Task Force is working on. Some key elements for ensuring progress are: (a) An improved surveillance of member states that face high deficits or high debt levels; (b) The development of a credible enforcement mechanism, with specific sanctions that would be imposed in a quasi-automatic manner. Those ex-ante agreed sanctions would serve as a deterrent for misbehaviour, including misreporting of statistics and misleading programs regarding budgetary consolidation. (c) Improved cooperation and coordination among member states to promote macroeconomic stability and ensure an enhanced standard of living for all citizens of the economic and monetary union. In this regard, the importance of solidarity among member states will be highlighted during difficult periods, as our fortunes are tied together.

With regard to the Greek situation at present, Mr. Orphanides offered praise to the Greek government for the courageous reform program that is currently underway. He stressed that with the successful implementation of the reforms we can look forward to a revitalization of the Greek economy. The reforms would boost the country's potential for growth and raise the welfare standards of the Greek people. The short-term pain experienced during the adjustment is most unfortunate but, at this very late stage, unavoidable in order to ensure a speedy restoration of the country's solid development prospects. The more the adjustment is delayed, the greater is the cost to the Greek economy and its citizens.

Next, in his presentation Mr. **Hardouvelis**, ranked the short- and intermediate-run risks to the Greek stabilization program, as perceived by financial markets, in the following order: (a) Will the recession end soon and how? (b) Will the problems of revenue generation be cured or could, instead, moral hazard dominate the attitudes of the Greek public? (c) Can a public backlash occur in H1 2011 as unemployment rises and incomes fall to a degree that could cause derailment of the stabilization program? (d) Will the government bond risk premia decline for the government to be able to tap the market again in about a year or two? (e) Will the banking system survive the crisis? Hardouvelis stressed there are credible answers to all market worries as the pace of reforms has picked up speed and Greek society appears receptive to the tough measures. The probability of success of the stabilization program is now very high despite the deepening recession, and that debt restructuring is out of the question as it is too costly for domestic and EMU stakeholders. Hence, markets have overreacted and appear oblivious to changes in the sources of risk that threaten the stabilization program. The high current spreads present a great opportunity to buy Greek bonds or sell Greek sovereign default swaps.

Hardouvelis also mentioned that in the long-run, Greece should not be written off investors' radar screens as it can resume growth rates close to the ones observed in the previous decade. Many factors point to that: (a) A strong and unlevered private sector with solid and prudent banks; (b)

Low capital intensity relative to the EU average, hence a need for infrastructure projects and with funding available; (c) A decline in real wages that would soon improve competitiveness, which in the service sector did not deteriorate tremendously over the last decade anyway; (d) A careful building of social institutions, a shrinking public sector and drastic structural reforms in the public sector, the educational system and in the various professions and market segments, will finally place Greece on a healthy and sustainable growth path with a more export-oriented and competitive economy and with gains estimated by some researchers at around 20% of GDP; (f) and the capturing the underground economy can improve not only tax revenues but also the closely watched figures of Debt /GDP.

In his remarks, Mr. **Gortsos**, emphasized that the recent international financial crisis (2007-2009) did not have any significant negative impact on the stability of the Greek banking system. Its current problems are a consequence and are closely connected to the Greek fiscal crisis instead. It is a liquidity problem and not a solvency problem. He also analyzed last year's developments, using various indicators related to the functioning of the Greek banking system. He particularly emphasized that, in contrast to other economies, the annual growth rate of total credit to the domestic private sector still remains positive (even though at a lower level) in Greece.

Next, Mr. **Meghir** and Mr. **Vayanos** argued that Greece must use the crisis as an opportunity to modernize its economy. In their view, the crisis is the result of excessive regulation, lack of investment in infrastructure and human capital, and rampant corruption. Profligate and wasteful government spending financed by borrowing over 30 years had covered up the problems and brought the country on the verge of insolvency. Meghir and Vayanos argued that while the reforms agreed between Greece and the EU/IMF go in the right direction, they should be complemented urgently by an even more ambitious reform program. For example, the liberalization of product and labor markets will be more effective if accompanied by an overhaul of the justice system, a strengthening of the Competition Commission, and a simplification of the tax code and the many other regulations that govern the interaction between companies and the state. Such measures will not only attract investment effectively, but also reduce incentives and scope for corruption.

Meghir and Vayanos called for the public sector to become more accountable, the pension system to be funded based on individual savings, and for hospitals to rely more on private management. Turning to competitiveness, they particularly pointed that Greece ranks at the bottom of international assessments on educational achievement and that the education system requires a complete overhaul with schools being able to make employment decisions and being subject to competition. They emphasized that a modern economy also requires a well operating social insurance system, designed to protect people from negative shocks, yet at the same time to not distort excessively work incentives.