

# Greece's Crisis: Testing the Viability of the Euro Project

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## Origins of the Debt Crisis

The graphs containing economic indicators for the major currency areas in the advanced sector of the world economy suggest that the euro area's debt crisis does not spring from some fundamental weakness in its overall performance [see Indicators 1 and 2, pp. 5–6]. Per capita incomes are similar to Japan's and within reasonable distance from those prevailing in the United States. Government deficits are lower than either in the United States or Japan and have grown less than in the United States during the global financial crisis. Debt levels also compare favorably while their growth is more subdued than in the United States and Japan. The euro area aggregate current account is balanced as opposed to Japan's surplus and the US deficit. Germany's substantial current surplus stands out as an exception.

Turning to the euro area's interior, however, interesting divisions emerge particularly between the periphery (Greece, Italy, Spain, Portugal, and Ireland) and the core (the remaining 11 countries—excluding Estonia). Income levels in the core are higher and the difference has widened during the global crisis. Deficit and debt levels are comparable but the dynamics of debt growth has been stronger in the periphery than in the core during the crisis partly because of deeper recession. The more pronounced difference concerns the current accounts. Large current deficits in the periphery are mirrored by equally important surpluses in the core, particularly in Germany, reflecting mainly differences in productivity and competitiveness.

The persistence of large external imbalances has transferred excess savings from the core to the periphery creating the conditions for extensive borrowing and the build-up of debt. Debt growth exposed the contradictions in the euro area's economic constitution: national debts are the responsibility of member countries, but the common currency is without a sovereign. The European Central Bank (ECB) cannot act as a lender of last resort—as most central banks do—which, in conjunction with the absence of common bonds (eurobonds), induced large-scale speculation on intra-European national debts. This explains the dramatic proportions that the euro area's debt crisis has acquired—threatening the very existence of the euro—in sharp contrast to the relative calm prevailing in fully fledged currency unions such as the United States and Japan. Centralizing European debt through issuing eurobonds, mobilizing sufficient rescue funds, and equipping the ECB with the full range of central banking powers would have saved the euro area from much pain as well as the survival risks it is facing.

However, moving in the direction of fiscal, economic and, eventually, political unification should go hand in hand with the correction of a critical defect in euro area's structure: the core-periphery competitiveness divide and the large and persistent external imbalances that generate excessive borrowing and debt growth.

Reinforcing the competitiveness of the periphery constitutes a key factor for overcoming the euro area's crisis. EU and International Monetary Fund (IMF) planners have been slow in grasping its importance. They have relied almost exclusively on austerity in an effort to promote fast-track fiscal consolidation. Structural reforms were sidelined. The result was deep and prolonged recession which, on the one hand, partially defeated the fiscal objectives and, on the other hand, created conditions that discouraged the promotion of the necessary fiscal and structural reforms. Societies need a stick as well as a carrot, in the shape of the prospect of economic recovery and job creation, in order to endure the losses in incomes and security resulting from market-oriented reforms. Euro area authorities, led by Germany, found refuge in the slow pace of reforms in individual countries so as to retard or avoid making progress in reconstructing the system of governance and assuming the corresponding financial and political costs.

Nevertheless, more than one trillion euros have been dispensed over the past two years in the cumulative efforts of the European Union, ECB, and private sector lenders to overcome the euro area's sovereign debt crisis. Today, however, we are in no better position than in the autumn of 2009 when the full scale of Greece's fiscal problem was revealed.

Repositioning the euro area in the global economic map requires a vision and a plan. It will not be the outcome of endless bargaining among short-sighted players whose paramount concern is to contain current losses without taking due account of longer-term gains.

### **Greece's Prospects**

The adjustment program imposed on Greece by the troika (European Commission, ECB, IMF) in May 2010 was seriously flawed. It placed too much emphasis on austerity, through tax rises and income cuts, and too little on reform. Its implementation, punctuated by delays, omissions, and outright failures, instead of correcting the planning defects, further accentuated them. The government, lacking a cohesive plan of its own, found it politically more expedient to apply horizontal austerity measures, hitting the less affluent social strata, than confronting the special interests (suppliers of state-owned enterprises, public-sector trade unions, closed professions) that are affected by—and, therefore, opposed to—reforms. A deep and prolonged recession, leading to a cumulative fall of GDP by 13 percent, prevented, through consistent undershooting of tax receipts, a substantial fall in the budget deficit. In the absence of the devaluation weapon, the reverse should be the case: less austerity and a longer time profile for deficit reduction,

alongside an aggressive, and tightly monitored, pursuit of reforms so as to accelerate productivity growth and bring down domestic costs.

These defects are now addressed in the new adjustment program agreed in the context of the second bailout loan and the associated debt reduction deal reached with private sector lenders. Privatization, opening up of products, services, and labor markets, deregulation, eliminating waste in the state sector, and abolishing unnecessary public entities, should proceed at a fast rate in order to reinforce competitiveness and create conditions for new investment and economic recovery.

The successful outcome of this effort crucially depends on the commitment to reforms, and the competence to carry them out, of the government that will emerge after the parliamentary elections expected to take place in about two months' time. On the basis of present poll data and likely trends, the two major parties, New Democracy and PASOK, may get shares of the vote adding up to about 50 percent to 55 percent. This compares to about 80 percent to 85 percent they were getting over the last couple of decades, but it is higher than current poll findings. New Democracy's share is likely to range between 30 percent and 35 percent while PASOK will register a substantial reduction—probably getting between 15 percent and 20 percent—but may still emerge as the second party. The parties of the left and the extreme left will substantially increase their share, reaching about one-third of the votes, while the balance will be held by extreme right-wing and other smaller parties.

This assessment, which may be thought of as a baseline scenario, assumes that the bailout agreement is properly completed without financial upheavals, and that no significant social unrest or disturbance of public order take place until the elections. Assuming, further, that New Democracy does not get an absolute majority of parliamentary seats—which, on the basis of the electoral law, is feasible with shares of the vote ranging from 36 percent to 39 percent—the government that emerges after the elections could be a coalition led by New Democracy and including PASOK. If such an agreement is not reached, and provided that numbers allow it, New Democracy could seek the support of the extreme right or other smaller parties.

To sum up, a pro-euro government is likely to emerge after the elections, reflecting the public's overwhelming preference (close to 80 percent) for staying in the euro area. It will lack, however, homogeneous parliamentary support and will face a vociferous left-wing anti-euro opposition both within and outside parliament.

The future course of Greece hinges on the capacity of the next government to rise up to the challenge of lifting the economy out of the present mess, which increasingly looks like a cul-de-sac.

The challenge is twofold. First, reforms must be effectively pursued and confidence in Greece's growth potential must be restored. The recent record does not augur well. The two previous

governments failed on this score, despite enjoying stronger positions, partly out of fear of the political cost but also because they lacked the required skills. It is uncertain whether the new political setup can—or will—do better than the preceding one. Moreover, a Monti-type government, supported by the two main pro-euro parties, does not seem to be an option. Neither the country's history nor its political culture sustain such experiments while the civil society does not produce politically minded technocrats in sufficient numbers so as to engage credibly on this course. Professional politicians will continue to have the upper hand.

Critical factors that will determine the effectiveness of the new government in rescuing the economy are thus its political strength and will to push forward with reforms and the skills it can master for implementing them. In this context it would be advisable to “outsource” the conduct of economic policy to a handful of extraparliamentary ministers who will commit themselves to stay out of politics after they complete their mandate.

Second, the euro area should support Greece's reform effort. Reversing the economy's free fall over the next two critical years of continued austerity and wage cuts requires countervailing action in the shape of pro-growth policies at the euro area level. These comprises reinforced economic policy coordination, easier monetary conditions, progress in fiscal unification (eurobonds, beefing up the European Stability Mechanism), as well as a European Marshall Plan to finance—through grants and ECB loans—investment in the austerity-stricken countries.

Helping Greece and other weaker economies addresses the euro area's structural problem, namely the core-periphery competitiveness divide. It will thus contribute to establishing longer-term economic stability. However important the contagion risks from a Greek default and eventual euro-exit are judged to be, letting Greece go under will be a severe blow to the credibility and viability of the euro project, notwithstanding the considerable security concerns it will raise in a critical geopolitical space.

Saving Greece is doable, provided that both the country and the euro area get their act together. Failure will inevitably pose the question “who's next?” Success, combined with a leap forward in European unification, will lay the basis for sustainable growth and a dynamic presence in the globalized world.

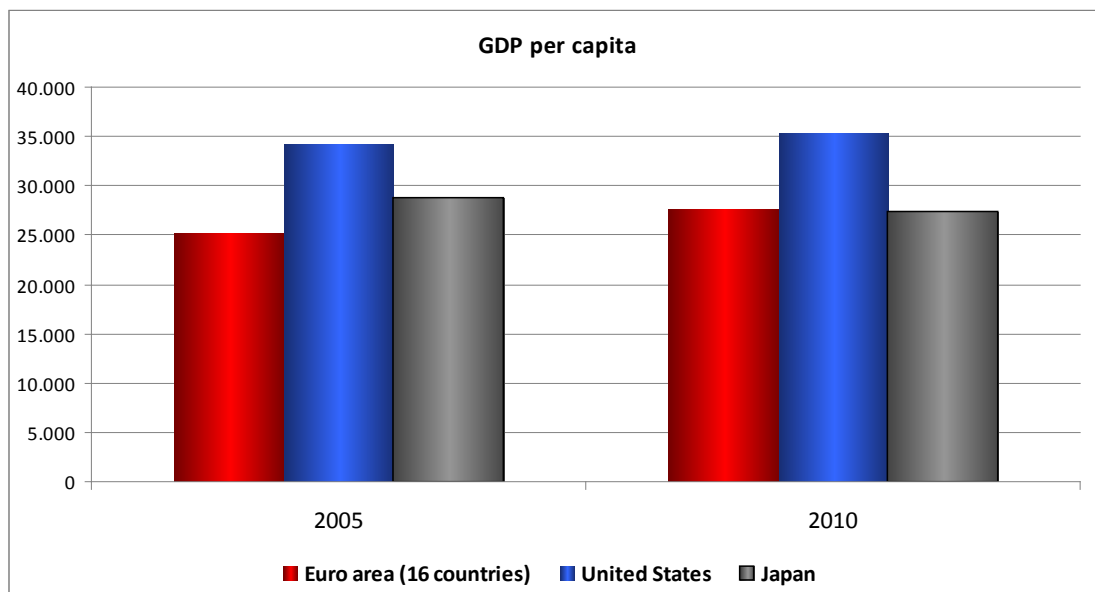
## DEVELOPED CURRENCY AREAS

### Indicator 1: GDP PER CAPITA

1st graph: GDP per capita comparison across developed currency areas (euro area, United States, Japan)

GDP/ CAPITA	2005	2010
Euro area (16 countries)	25.200	27.700
United States	34.300	35.400
Japan	28.800	27.400

Source: EUROSTAT



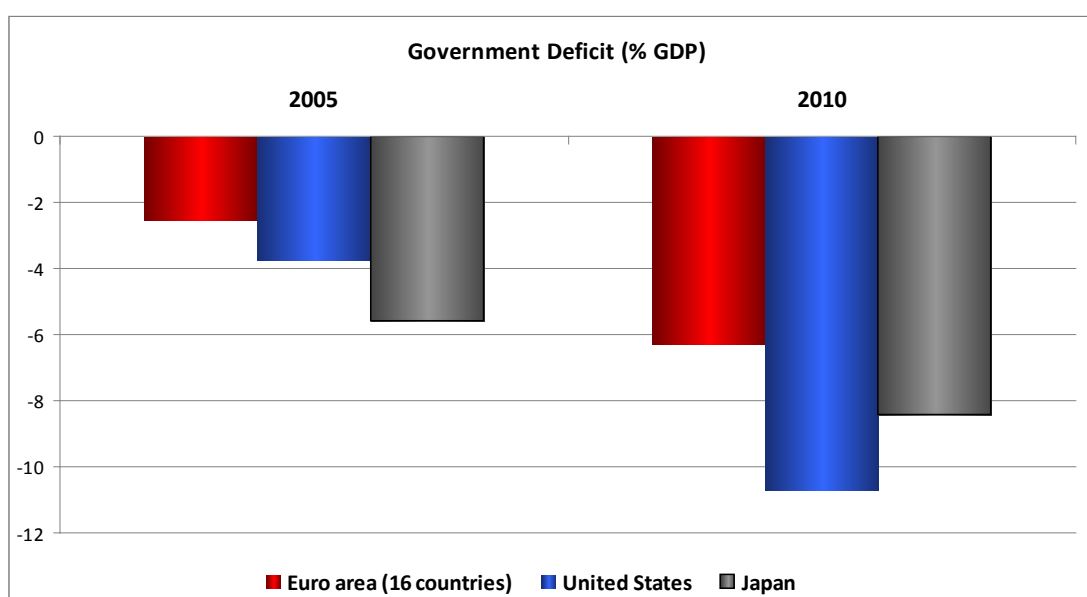
Source: EUROSTAT

## Indicator 2: GOVERNMENT DEFICIT

2nd graph: Government deficit comparison across developed currency areas (euro area, US, Japan)

Government deficit (percent GDP)	2005	2010
Euro area (16 countries)	-2,5	-6,3
United States	-3,7	-10,7
Japan	-5,6	-8,4

Source: EUROSTAT, European Central Bank



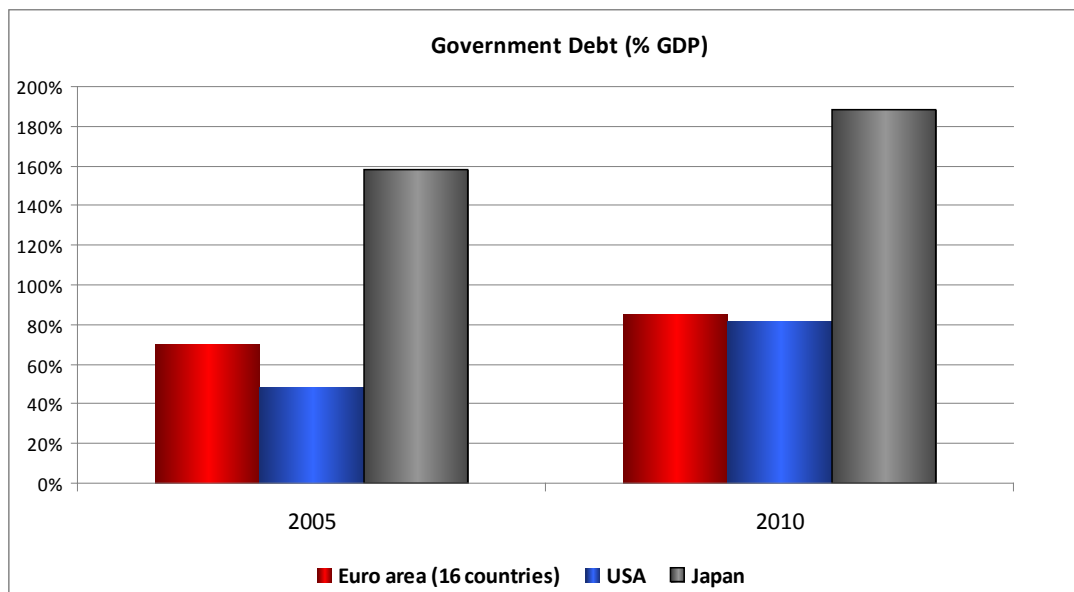
Source: EUROSTAT

### INDICATOR 3: GOVERNMENT DEBT

Unit: Gov.debt % GDP (EUROSTAT)

3<sup>rd</sup> graph: Comparison across developed currency areas (Euro area, US, Japan)

Government debt % GDP	2005	2010
Euro area (16 countries)	70,2	85,5
USA	49,2	82,4
Japan	157,9	188,4



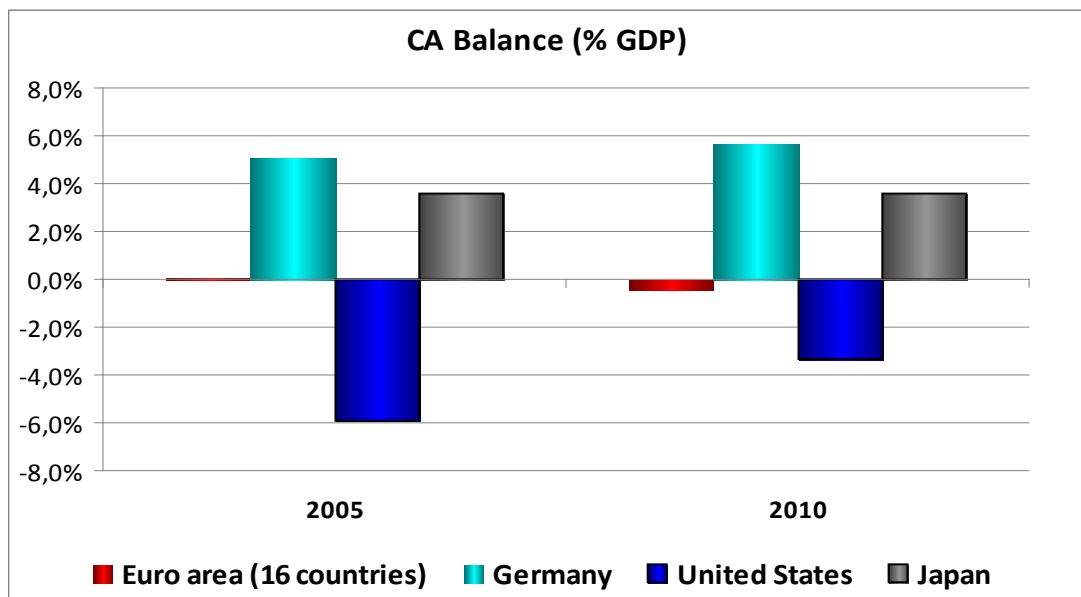
FIGURES FOR US, JAPAN FROM ECB

#### INDICATOR 4: CURRENT ACCOUNT DEFICIT

Unit: Current account surplus/ deficit % GDP (EUROSTAT)

4<sup>th</sup> graph: Comparison across developed currency areas (Euro area, Germany, US, Japan)

Balance of the current account	2005	2010
Euro area (16 countries)	0,1%	-0,4%
Germany	5,1%	5,7%
United States	-5,9%	-3,3%
Japan	3,6%	3,6%





## ***EURO AREA PERIPHERY AND CORE COUNTRIES***

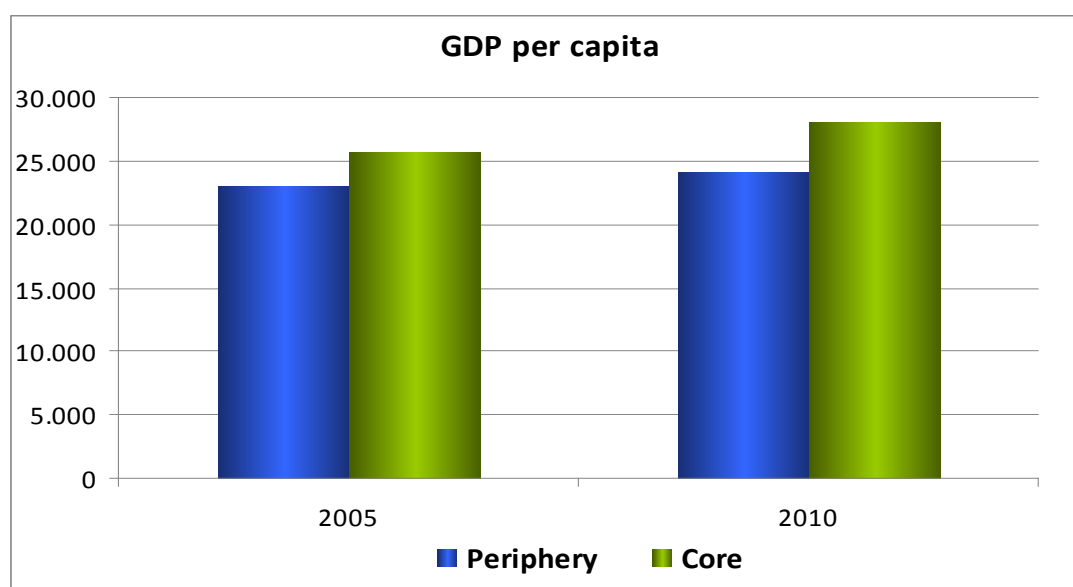
### **Indicator 1: GDP PER CAPITA**

Unit: Euro per inhabitant (EUROSTAT)

#### **5<sup>th</sup> graph: Comparison between Euro area periphery and core countries**

Unit: Millions of PPS (Purchasing Power Standard)/ Population (Eurostat)

<b>GDP/ CAPITA</b>	<b>2005</b>	<b>2010</b>
<b>Periphery</b>	23.054	24.191
<b>Core</b>	25.688	28.055

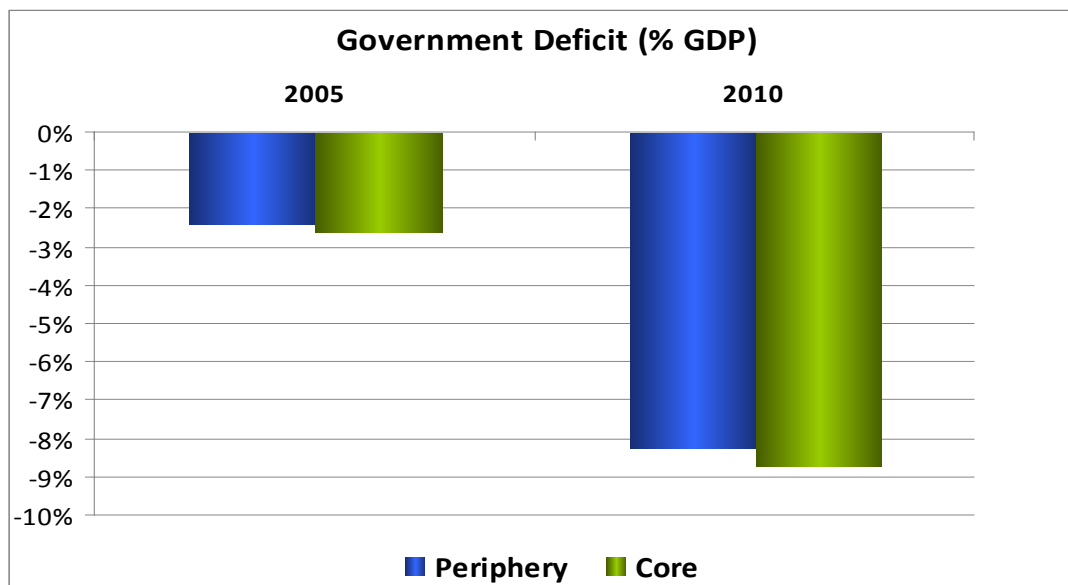


## Indicator 2: GOVERNMENT DEFICIT

Unit: Gov.deficit % GDP (EUROSTAT)

6<sup>th</sup> graph: Comparison between Euro area periphery and core countries

Government deficit % GDP	2005	2010
Periphery	-2,4%	-8,2%
Core	-2,6%	-8,7%

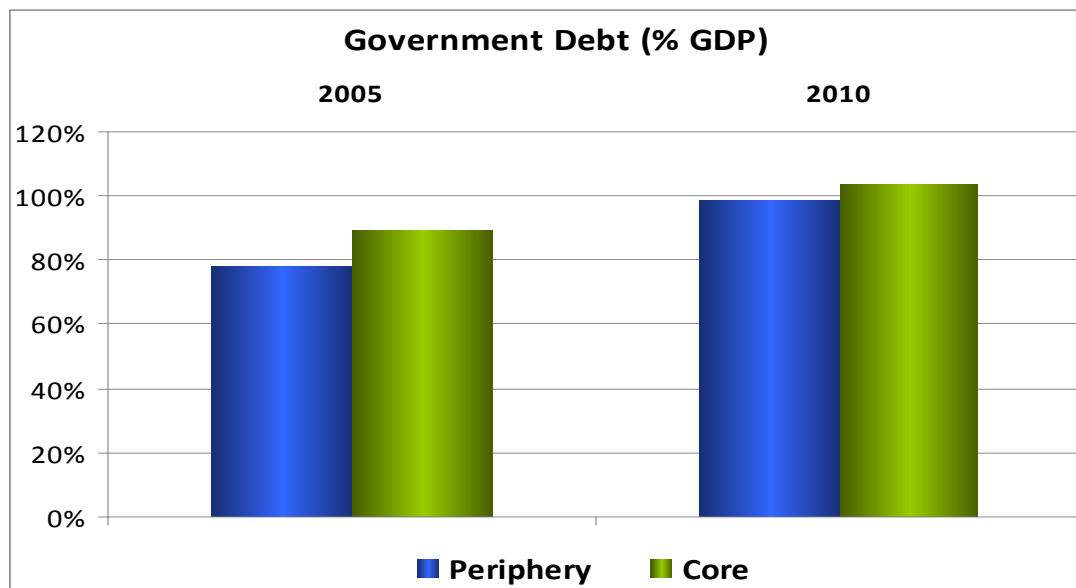


### INDICATOR 3: GOVERNMENT DEBT

Unit: Gov.debt % GDP (EUROSTAT)

7<sup>th</sup> graph: Comparison between Euro area periphery and core countries

Government debt % GDP	2005	2010
Periphery	78,5	98,6
Core	89,3	104,0



## INDICATOR 4: CURRENT ACCOUNT DEFICIT

Unit: Current account surplus/ deficit % GDP (EUROSTAT)

### 8th graph: Comparison between Euro area periphery and core countries

The imbalances within euro area are far from obvious and constant over time

Current account % GDP	2005	2010
Periphery	-4,4%	-4,5%
Core	3,0%	2,7%
Germany	5,1%	5,7%

