"The Greek Crisis: Where Are We? Where Do We Go from Here?"

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BU Law School

- US: GDP recovering, unemployment more slowly
- EZ: GDP and unemployment, both more slowly
Stage two: the public debt crisis in the Eurozone

The recession has been deep but relatively short-lived!

GDP growth 2006–12:
Eurozone Crisis: Greek Context

- Elections of 2012, May and June, dramatically changed political landscape: New Democracy, leading coalition with the virtually extinct Pasok.
- Debt continues to be huge.
- Reforms being legislated, but not easily implemented. Greece’s Eurozone partners delivered and may have to deliver more.
- Question: has Greece reformed sufficiently? Ready to face the future?
- Even if Greek economy were to move forward as forecast by the Troika, will not be able to return to its real income of 2008 until after 2030! (IMF, July 2013 Report)
Eurozone Crisis: European “Periphery” Context

- Greece, Portugal
- Ireland, Cyprus
- Italy, Spain
| Source: Eurostat, IMF World Economic Outlook, Eurobank Research. | Note: CY=Cyprus, GR=Greece, PT=Portugal, IR=Ireland, SP=Spain, IT=Italy. GDP reflects real GDP and the growth is annual. | Source: G. Hardouvelis, Tassos Papadopoulos Conference (2013) |
Eurozone Crisis: Leading up to the crisis

- Convergence of interest rates
- Massive inflows of capital into the European Periphery
- Massive build-up of debt
- Greece: public, government borrowed to finance twin deficits: consumption above what economy produced internally and externally
We discuss how these dynamics played out in distinctive ways in five specific countries. The first four countries—Spain, Ireland, Greece, and Portugal—are the four countries with some bailout programs from the European Union as of early 2013. In these countries, instead of the euro leading to a modernization of peripheral Europe, it became the sedative against any reform. While we believe that similar dynamics operate in other countries, such as Italy and France, we will not explore those examples here. By way of contrast, we then turn to a discussion of Germany, which did not enjoy a loosening of its financing conditions as a result of the euro. Faced with a limited margin of maneuver and a stagnant economy, Germany chose the path of structural reforms, and as a result, the underlying divergence in economic policies and institutions between Germany and the other four countries discussed here increased, rather than diminished, as a result of the dynamics induced by the euro.

The Political Economy of Reforms, Institutions, and Monetary Unions

The euro project had four goals (see James, 2012, for a historical narrative): 1) to build a unified European identity; 2) to eliminate nominal exchange rate fluctuations and the imbalances that those could create (and in particular, to channel the export dynamism that Germany had displayed since the 1960s); 3) to create a
sustainable external debt positions, by 2010 all four countries had reached net external debt (the value of the domestic assets owned by foreigners less the value of the assets that nationals owns abroad) close to 100 percent of GDP, through the accumulation of either public (Greece and Portugal) or private (Spain and Ireland) debt. These unprecedented financial booms allowed these countries to expand their public budgets, paying for this either directly through historically cheap debt issuance, as in Greece or Portugal, or through the tax revenue related to the real estate bubble, as in Spain and Ireland.

The consequences for economic reform of such a windfall would not have surprised researchers studying foreign aid. Alesina and Drazen (1991) have argued that the political decision process for economic reform is a war of attrition in which all groups try to delay the reform (with a cost to all) until one group has no more “budget” and gives up, bearing the largest cost. Casella and Eichengreen (1996) show that, in this context, foreign aid will delay concessions and reforms. Svensson (1999), in a game-theoretic model, shows that any windfall (including aid) increases rent-seeking and reduces productive public spending, and he presents empirical evidence (see also Drazen 2000) consistent with the proposition that aid delays reforms. Vamvakidis (2007) extends these arguments to the case of financial booms: he uses a panel of 81 developing and emerging countries to show that increases in external debt are correlated with slowdowns in economic reforms.

Figure 2
External Indebtedness
(net international investment position as a percentage of GDP)

![External Indebtedness Chart]

Source: Eurostat.

\[ J. \text{Econ. Persp.} (2013) \]
Cobbling Together a Response to the Sovereign Debt Crisis

Greece was the first country to be shut out of the bond market in May 2010, with Ireland following in November 2010, and Portugal in April 2011. (In June 2012, Spain and Cyprus also sought official funding. At the time of writing, it is unclear whether Spain will require only a limited form of official funding to help it recapitalize its banking system or a larger-scale bailout.)

In each of the three bailouts, joint European Union/IMF programs were established under which three-year funding would be provided on condition that the recipient countries implemented fiscal austerity packages and structural reforms to boost growth (especially important in Greece and Portugal) and recapitalized and deleveraged overextended banking systems (especially important in Ireland). The scale of required funding far exceeded normal IMF lending levels, so the European

Figure 2
Yields on Ten-Year Sovereign Bonds, October 2009 to June 2012

(percent)

Source: Author’s calculations based on data from Datastream.
Troika in Charge

- IMF, ECB, EZ/EC assisting Greece, Portugal, Ireland
- Policy option: restructuring of debt, austerity, reform
- Policy option: restructuring of debt, reform plus a little bit of inflation, (4%)
- Austerity prevails
Prospects for the future

- Even if Greek economy were to move forward as forecast by the Troika, will not be able to return to its real income of 2008 until after 2030!
- Will the social structure sustain itself?
- Will the political structure?
- Forgiveness of debt (now mainly official, ECB, EZ, IMF) appears difficult?
- There is only one solution?
Prospects for the future

- There is only one solution: **Reform, Reform, Reform, . . ., Reform!**
- This applies to the entire Eurozone Periphery, too.
- Loss of competitiveness led to China’s (and other emerging economies’) advances in market shares of EZ periphery.

*Source: Ruo Chen, Gian Maria Milesi-Ferretti, and Thierry Tressel, External Imbalances in the Euro Area, IMF WP/12/236, Sept. 2012*