

Interview to the Finnish newspaper “Helsingin Sanomat” May 31, 2011

by Basil Dalamagas
Professor of Economics, University of Athens, Greece

1) Greece is now under hard pressure to take the necessary steps to rescue its economy in order to get the fifth tranche of the aid package. Do you think that announced measures are sufficient to stabilize the Greek economy and to convince the European and IMF authorities?

Actually, there are three sources of pressure on Greece.

Firstly, it is the credit-rating agencies which have awarded the junk status to the Greek government paper, have pushed the corresponding spreads to excessively high levels and have largely shut Greece out of the private markets.

Secondly, the squabbling inside Europe also puts pressure on Greece, with the variety of opinions expressed by southern and northern (mainly Germany) euro-area nations, by the ECB officials, by the head of the euro-group council of euro-zone finance ministers and so on. For example, the ECB warns it may pull the plug on funding for Greek banks in the event of any restructuring of Greece’s government debt, either through a reduction in the face value of bonds (haircut) or by an extension of maturities. German and other euro-area nations favor a soft restructuring or maturity extension, given the size of Greece’s debt burden and its bleak economic prospects. The head of euro-group council has opened the door to a kind of re-profiling Greece’s debt, which however is viewed as tantamount to default by ECB officials. Re-profiling aims at postponing at least some of the debt repayments — amounting to € 66 billion — Greece must make in 2012 and 2013.

Lastly, the French Finance Minister has stated that rescheduling that would create a credit event is off the table.

In sharp contrast to these views, sovereign rating analysts and financial markets claim that a detrimental to the creditor’s debt extension with a haircut of at least 50% in the principal is necessary to handle Athens’s fiscal crisis in the medium-to-long run.

The last source of pressure should be sought within Greece: Mounting tensions in the government party, unwillingness on the part of the opposition leaders to compromise over the terms of the stabilization program and the majority of the population in deep distress, as personal incomes drastically fall, unemployment rises to unprecedented levels and

future prospects are uncertain, not to say dismal, in the context of an ever-growing suspicion over extensive political corruption.

The main reason underlying the emergence of the aforementioned three kinds of pressure is the government failure to achieve the fiscal stabilization targets (raising revenue, cutting budget deficit), to carry out successfully the privatization program and to implement the enacted structural reforms in both the labor market and the public entities (deregulation, substantial reduction or merger of public organizations).

In an attempt to disperse fears of undercutting austerity efforts and to avoid further deterioration in its credit worthiness, the Greek government, in collaboration with euro-zone nations and IMF-ECB officials (troika), is currently redesigning the medium-term stabilization Pact in three directions:

- **To eliminate the diversion from the deficit-cutting efforts which are deemed to be critical to regain the trust of financial markets?** To this end, additional measures of € 6.4 billion, in the form of tax increases and expenditure cuts, will be initiated to ensure that the budget deficit will not exceed the predicted level of 7,4% of GDP in 2011. Additional measures of the same size, that is € 6 billion per year for the period 2012-2014, will be adopted to ensure that the fiscal deficit will fall to 1% of GDP in 2015 and the resulting primary surpluses from 2015 onwards will be used for repayments of maturing debt.
- **To account for the delays in the implementation of the privatization schedule, special purpose vehicles (SPV) will be established.** Expected revenues of about € 50 billion from the utilization of the state property, mainly from real estate and infrastructure (tolls, state lotteries etc.), as well as government shares in public entities, will be transferred to these independent SPVs, with some of the members of the board of directors coming from the troika. The amount to be collected from privatizations will be used to reduce the public debt-to GDP ratio by as much as 22 percentage units (from 161% to 139%). The above measures will be announced by the Greek government and the delegation of European Commission, ECB and IMF officials charged with presenting a report on Greece's progress in the next few days. These measures are expected to satisfy the IMF's rules which require that a full-year plan must be in place before further disbursements can operatively happen. They will also pave the way for additional official lending by the EU and for funding another bailout schedule of about € 65 billion, given that Greece will fail to meet its original goal of returning to capital markets by the middle of next year.
- After a period of slackness, **structural reforms** which have already been approved by the Parliament **will gain momentum**, as reactions on the part of the special interest groups tend to weaken, in view of the

ongoing recession in economic activity. Structurally reforming labor and product markets and improving public sector performance and institutional framework will raise productivity and competitiveness, thus reinforcing the growth prospects.

Job done? Well, no. The key question is whether the revised medium-term stabilizations program would succeed in persuading the financial markets that Greece, from now on, will fully respect in practice the terms and conditions of the second lending agreement with IMF-ECB-Euro zone governments and no other deviations from the new stabilization Pact will take place at the time of applying it.

How realistic is the assumption that, this time, Greece will be able to conform to its obligations arising out of the revised stabilization Pact? Given its poor historical records in this area, the deep recession and the negative growth rates in the current period, the reputation losses and the disruption of the political system — which increase the political cost of applying painful measures — and the creeping discontent of the Greek people, one might come to the conclusion that the possibility of success is low. However, things are now different. An increasing portion of the population seems to share the opinion that default or debt restructuring with haircut — which in an extreme case might be accompanied by an exit from the euro-zone and re-introduction of drachma — would be a disaster for current and future generations and that the implementation of the new stabilization programme may be an one-way path and the last chance for avoiding the worst scenario of national isolation in poverty. If this shifting in public opinion's attitude toward the debt problem proves to be true, the possibility of complying with the instructions of the troika may be high enough to make a difference to Greece.

2) To look back, it has now been a year since Greece asked for EU's and IMF's help. What is your opinion about your government's actions so far? Have they succeeded? What should be done to change things?

The fiscal consolidation program was implemented according to the predictions of the stabilization Pact in the course of 2010, with the fiscal deficit being reduced from over 15% of GDP to 9,4%.

It was the first quarter of 2011 that the revenue realizations of the ordinary budget appeared to lag behind and expenditure to exceed the predetermined targets, pointing to an escalation of the budgeted deficit from 7,4% to 9,4% of GDP. Even though this deficit deviation will be restored by the complementary measures of the forthcoming new stabilization program, the question of what gives rise to budget disturbances need to be answered. Two explanations seem to be reasonable:

- The tax-collecting and tax-auditing mechanisms of the Ministry of Finance are not well organized to fully exploit the tax capacity of the population or to drastically reduce the tax evasion in the underground economy. In addition, the government is hardly prompt in shrinking the size of the public sector by decreasing the number of the public employees or by curtailing the power of the public-sector Unions.
- The serious fiscal and structural distortions, as well as the over-indebtedness of Greece, are the outcome of a 30-year mismanagement of the public sector by the political parties. These macroeconomic distortions cannot be restored in a short 2-3 year-period. However, the bailout program has imposed a three-year adjustment period and it counts on Greece to raise € 27 billion on its own in long-term debt markets next year (and more than € 30 billion in 2013). Such terms lead to deep recession with weak growth prospects.

3) What is your opinion about the previous government's policies and the false public sector's statistics?

The Greek governments of the last three decades adopted an expansionary fiscal policy with a view towards financing social, consumption-type programs.

With tax revenues lagging behind expenditure, debt-financed policies raised the debt-to-GDP ratio from 30% in 1980 to 90% in 1990. Coalition governments in the early 1990s and the Olympic Games in 2004 pushed this ratio to above 100%. Creative accounting and debt-hiding policies helped presenting a false image of the real economic conditions to the rest of the world. As well known, fiscal deficits are transformed into increased private incomes and consumption, mainly of imported goods. Thus, the fiscal deficits turned into foreign balance deficits. In addition, deregulation of the banking sector and, in general, of the money-capital markets (lower interest rates etc.), upon entering the EU, fostered a consumption spree and impinged serious damage on competitiveness. It is now difficult to persuade people that their living standard has to be drastically lowered to eliminate excess demand.

4) What is your own idea as to how to stabilize Greece's economy? How can the public sector be in balance and curtail the private

consumption at the same time? This might be a fairly difficult combination?

The key economic problem of Greece is that people as a whole consume in excess of their productive capacity, as noted before. Equilibrium will be restored when excess demand is minimized. There are two ways for curtailing excess demand. The first one is to increase domestic supply or production, that is to score positive growth rates. However, growth requires investments, i.e. foreign capital inflows — since domestic capital is scant — a friendly environment to entrepreneurship (limited bureaucracy and a minimum of state intervention) and favorable demand expectations. None of these three requirements is presently met.

The second way out of the economic crisis is to reduce demand. This is the area where the emphasis of the stabilization program is being placed through both wage cuts in private and public sectors and raising unemployment rates. In this case, fiscal consolidation programs help restoring long-run equilibrium in the economy.

5) From your point of view, how long does it take to get the public sector in balance and to prompt growth in the private sector? Perhaps, 10, 15, or 20 years?

It is difficult to predict the date of exit from the present state of over-indebtedness and the accompanying private-sector economic crisis. In the 30 year-period (1980-2009), the per capita GDP almost doubled but a portion of this increase was demand-oriented, i.e. it was funded by excessive public (and private consumers') borrowing. On the other hand, the stabilization measures of the last two years (2010-2011) led to an 8% reduction in GDP.

Assuming that approximately half of the 100% GDP growth during the period 1980-2009 was attributed to excess demand, Greece will need roughly 20 years to reach the equilibrium level of the year 1980 (with no budget deficits and very low trade balances), with an average 2% yearly reduction in the living standard. However, positive growth rates — if attained — in the coming years will certainly lower the adjustment period.

6) What is your realistic opinion as to how to get Greece in “dry hands» out of the current crisis?

The only way for Greece to handle the debt crisis and avoid default is to fully conform to the terms of the present and any future bailout agreements with the troika. Repeating the current diversions from the stabilization rules will dramatically reduce the patience of the Euro-zone leaders and will escalate the hostility of the European public opinion to any other rescuing plan for Greece.

7) Some other thoughts about the economic situation in Greece or in Europe as a whole?

Provided that Greece will efficiently implement any bailout agreement, there would be no excuse for the euro-zone governments to interrupt any kind of aid or support, as debt restructuring, irrespective of the particular form it would take, is apt to undermine the coherence of the euro-zone and the strength of the common currency.