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# Regional Competitiveness Initiative

RCI Sarajevo

# The Greece-Euro Crises

## and their impacts in

# Eastern Europe


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# Issues Discussed

- Greek crises: debt & competitiveness
- How these crises came about
- Bailout Greece? Yes/no? If yes, how?
- Eurozone in crisis & dramatic responses on May 9-10: facts & interpretations
- Competitiveness: Germany vs Greece
- Ways to improve competitiveness
- Implications of the crisis for East Europe

# Greece's Dual Crises



Greece faces two distinct but interrelated crises:

- Unable to service its huge (300b euro) sovereign (govt) debt, as scheduled

- Has suffered major loss of its regional and international competitiveness and does not know how to regain it

What are the reasons? What options?

# Q: Reasons for Greece's Sovereign Debt Crisis?



A: Consistently failed to live up – often by very large margins - to its '92 Maastricht & '97 SGP* treaty obligations:

- Low inflation (max +1.5% above …)
- Nominal "***r***" max 1.5% above ….)
- Budget balance; deficit < 3% of GDP*
- Cumulative govt debt < 60% GDP*
- Two-years in ERM-II (ER w/I +/- 15%)
- Independent central bank

# Q: How Could this Be Allowed by the EU?



1. France defeated German insistence on automatic fines for breeching the SGP; politics would rule.
2. Belgium & Italy were admitted in 1999 with debt/GDP ratios of 120 &130% of GDP
3. Ireland admitted with a 4.7% inflation rate
4. Greece qualified a year late via “creative accounting” (not alone)
5. Non-compliance even by Germany 2002-03

# The Original Eurozone 12 Tried to Integrate Two Blocs



“North”-“hard-currency”-fiscally prudent

- **Germany**, The Netherlands, Belgium, Luxembourg, Austria, Finland (Sweden)

“South”-”soft-currency”-fiscally loose

- Portugal, Italy, **Greece**, Spain (PIGS) = Mediterranean; some include Ireland

Straddling the middle: France

# Before 1999



- The Northern bloc countries periodically revalued (appreciated) their ERs, while
- The Southern bloc repeatedly devalued (depreciated) their ERs

Strong pressures in all countries to permanently fix intra-EU ERs.
That was to be achieved via the EMU:

- ECB in charge of monetary policy

- All members to observe the SGP

# After 1999



- The eurozone's common nominal "***r***"
  - translated into a high "***real r***" in Germany (Northern bloc), contributing to low growth and recessions. (German reunification!)
  - translated into a low "***real r***" – a huge gift to Greece (the entire Southern bloc). This triggered an explosion of credit, economic boom = rapid growth, initially narrowing the gap with Germany & the Northern bloc.
- EMU = new permanent prosperity era?

# Greece (the PIGS) Received Substantial Multi-year "Gift"



Q: Was the gift (ability to borrow large sums on extremely favorable terms) used wisely, to enhance future earnings capability or to finance excessive private and public consumption and to sweep long-standing problems under the rug?

A: Greece (the PIGS) did more of the latter! Greek debt is largely foreign owned (just like H's). Very large deficits during the 2000-2007 boom years (just like H!). And big loss of competitiveness (from a strong base in 2000).

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# Global Recession (2008-09) and Sovereign Debt

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Dramatic worldwide explosion of govt deficits:

- cost of bailing out financial institutions
- extra spending to counteract declines in output and employment
- cyclical revenue losses (taxes down, unemployment comp, etc. up)

Deficit and debt levels have soared. Sovereign debt of the developed world (not of emerging economies!!) is huge global concern

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# Sovereign Debts and Deficits Compared

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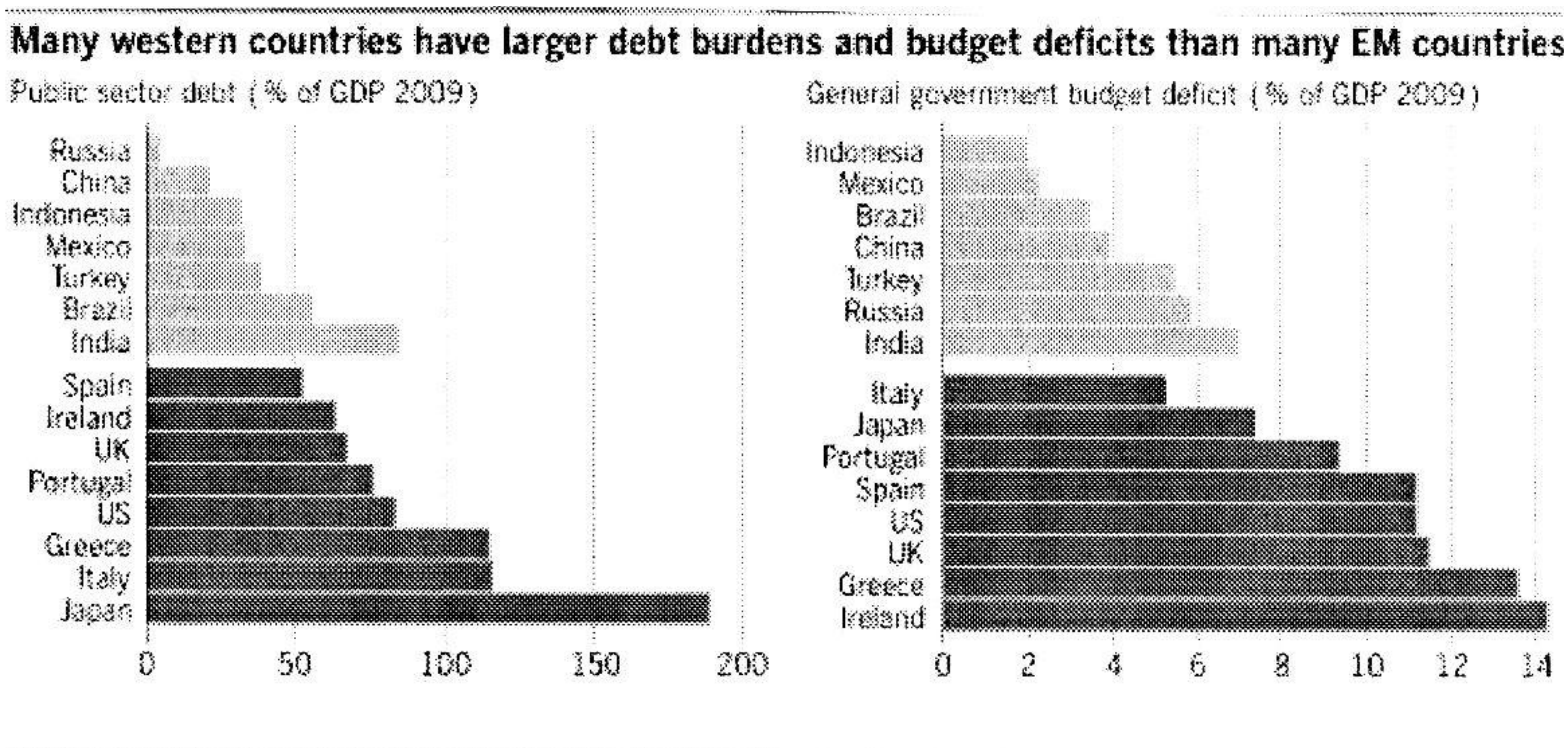

# Greece Is Insolvent!



- Big concern about the deficit and debt levels of Greece (and of the other PIGS to a lesser degree) hit the markets only a few months ago. Why so late?
  - Last October Greece's new govt revealed the extent of falsification. Ex: 2009 deficit revised, successively, from 3% to 14% of GDP!
  - The assumption that the eurozone stands behind all eurozone govt debt began to be questioned.
  - The eurozone authorities' limp response & public bickering scared the market and invited a horde of speculators, selling Greek (PIGS) debt & the euro

# January – April: Should Greece Be Bailed Out?



Yes, to avoid default …EMU may collapse

Yes, others have also been helped

No, forbidden by the Maastricht Treaty & the ECB charter

No, why reward …

No, it is no use to postpone the day or reckoning, Greece is insolvent!

# April: Greece Is Offered Conditional 110b Bailout



- Eurozone: 80b + IMF 30b
- Very tough conditionality
- Responses in Greece
  - Govt - Public
- Northern bloc (Slovakia & Slovenia) response
  - Govt - Public
- Market response:
  - Tough conditionality is unlikely to be met
  - The bailout only postpones the inevitable
  - May 7-8: Panicky selloff of Greek (and the PIGS') sovereign bonds. **Eurozone crisis!**

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# Dramatic Eurozone Actions During Weekend of May 9-10

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1. EU 27 enlarged “balance of payments loan facility” from 50b to 110b euro
2. Established a 440b euro “govt-backed loan guarantee facility”. IMF added up to 250b euro additional = 690b euros. 1 + 2 = 750b
3. The first time ever, the ECB buys “underpriced” PIGS govt bonds
4. Fed, ECB, etc opened “swap” lines

# Consequences of Eurozone's Crisis Response



- Rebuffed & warned the speculators …
- Avoided/postponed a new banking crisis by guaranteeing all eurozone gov bonds
- The Eurozone moved toward fiscal integration (new transfer channels)
- Placed the survival of the EMU at the mercy of eurozone's weaker members because …..

# Greece's Second Crisis: Loss of Competitiveness



- During the last decade, Greece (and the other PIGS) suffered large and sustained declines in their regional and international competitiveness. No way is seen how to regain competitiveness, given that their currency is the euro!

# Competitiveness: Germany Versus Greece



## Germany

Following a decade of hardships (the 1990s), owing to the huge cost of reunification (and large welfare-state burdens), Germany introduced major reforms (lower taxes, incentives for hiring and working, sustained wage restraints), which yielded big gains in price and quality competitiveness

# Competitiveness (cont’d)



**Germany** (cont’d)

- As domestic demand has remained weak, resources were shifted to X
- In spite of a 40% rise in the euro against the $ (2003-2008, see Chart), Germany remained the world’s largest exporter until this year (China just became #1),with huge current-account surpluses

# The USD/Euro ER 1999-2009



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# Competitiveness (cont'd)

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**Greece**

- Wage increases and inflation higher than in Germany
- Large current-account **deficits** (at 15% of GDP, highest in the eurozone in 2007; still 11% in 2009)
- Civil servants retire at 53 (versus at 67 in Germany)
- Nat'l S rate very low; 126$^{th}$ among 133

# Competitiveness (cont'd)



**Greece** (cont'd)

- Unreported economy 25%
- Tax evasion is national pastime
- Pervasive corruption
- Widespread government clientelism
- L-market inflexibility; one of EU's most "closed" economies; bus start difficult & costly
- Govt GDP share rose from 44% to 52%
- Cost of public adm 7% of GDP vs 3% in EU

# Comparative Unit Labor Cost Indices, 2000-2009



# Options to Improve Competitiveness



1. Devalue the ER. Today = leave EMU. This would be catastrophic because
   - 50% dev. = double debt-service burden
   - All contracts in euros – private defaults
   - Would trigger a banking crisis
   - Would accelerate inflation, eroding the initial advantages of devaluation

**The substantial euro decline in 2010 helps the PIGS outside eurozone**

# Options to Improve Competitiveness (cont'd)



2. "Internal devaluation" = cut wages to reduce costs & the P-level.

- Extremely difficult to do politically!
- Increases unemployment
- Reduces nominal GDP, ups debt ratio
- Expectation of further P declines leads to postponed spending, down spiral

# Options to Improve Competitiveness (cont'd)



Internal Devaluation (cont'd)

- Nevertheless, Estonia, Latvia, Ireland have been doing it for two years!
- Greece, Spain & Portugal just started
- The Baltics' unique situation, with their euro-pegged ERs

# Options to Improve Competitiveness (cont'd)



3. Structural Reforms (= supply-side measures)

Remove/reduce impediments to the efficient allocation of resources. Large gains are possible

- Intelligent privatization of SOEs
- Ease the establishing/operating a business
- Market, including L-market, efficiency
- Tax reforms - Better regulation
- Reduce corruption, the public sector

Difficult to do politically; a crisis may help

# Options to Improve Competitiveness (cont'd)



4. Trade partners with large CA surpluses (Germany!) should stimulate domestic demand

   - Issues and arguments

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*A fundamental, LT issue for the entire EU: What vision - economic growth model – can it articulate and implement to accelerate growth (projected to be max 1.5% p.a. for years) and stop its rapid decline (as its population is ageing) in relative global economic power?*

# Implications for Eastern Europe



1. The EU's large sovereign debt problems reinforce West Europe's projected slow growth (one of my main conclusions at last year's Kiev conference). This is not good news for East Central Europe & the Balkans
2. The EU's financial, economic and political problems is reducing its receptivity to quickly admit new members from the Balkans
3. The eurozone's enthusiasm for admitting the remaining 8 EE members of the EU has waned (although eventually they must join, assuming that the eurozone survives)

# Implications for Eastern Europe (cont'd)



4. The above means that the eurozone will insist not only on the strict observance of the Maastricht criteria, but will also assess carefully the prospects that an applicant country will continue with responsible fiscal policies. The markets are likely to be less tolerant as well with imprudent fiscal policies.

# Implications for Eastern Europe (cont'd)



5. The eagerness of the three Baltic countries to adopt the euro has not diminished in spite of the euro's troubles
6. However, in the other five EE countries (Poland, Czech Republic, Hungary, Romania, Bulgaria), public & expert support for the earliest possible adoption of the euro has greatly diminished. The majority prefer delay.

# Implications for Eastern Europe (cont'd)



7. The impact just stated has positive as well as negative aspects:
   - Positive: Joining the eurozone without being well prepared would backfire
   - Negative: Giving lower priority to meeting the Maastricht criteria might well encourage less responsible monetary, fiscal and structural reform policies

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# Implications for Eastern Europe (cont'd)



8. The ability of a new eurozone member to maintain or enhance its regional and international competitiveness before and after it adopts the euro depends on pursuing responsible fiscal policies as well as on the continued implementation of the many structural reforms that are still needed.

# Implications for Eastern Europe (cont'd)



9. Depending on the conversion rate at which an EE country will adopt the euro, the new member can obtain large initial gains from membership. It is essential that the authorities don't make the same mistake as Greece (and the other PIGS) made after they joined the euro.

# Implications for Eastern Europe (cont'd)



10. A new banking crisis in Western Europe that could be triggered by (the seemingly unavoidable) default on Greece's sovereign debt will adversely impact EE and the Balkans because the overwhelming share of their banks are subsidiaries of West European parents

# Implications for Eastern Europe (cont'd)



11. Greek banks - with 1200 outlets in Bulgaria, Romania, Serbia, Albania, and Macedonia - own about 15% of these countries' banking assets, totaling about $95 billion.* Serious troubles in the Greek banking sector would have major adverse financial consequences in these countries.

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* *Financial Times,* March 18, 2010.