SOME THOUGHTS ON THE UNDERLYING CAUSES OF THE CRISIS IN GREECE AND THE DAY AFTER

Greece is not a unique case

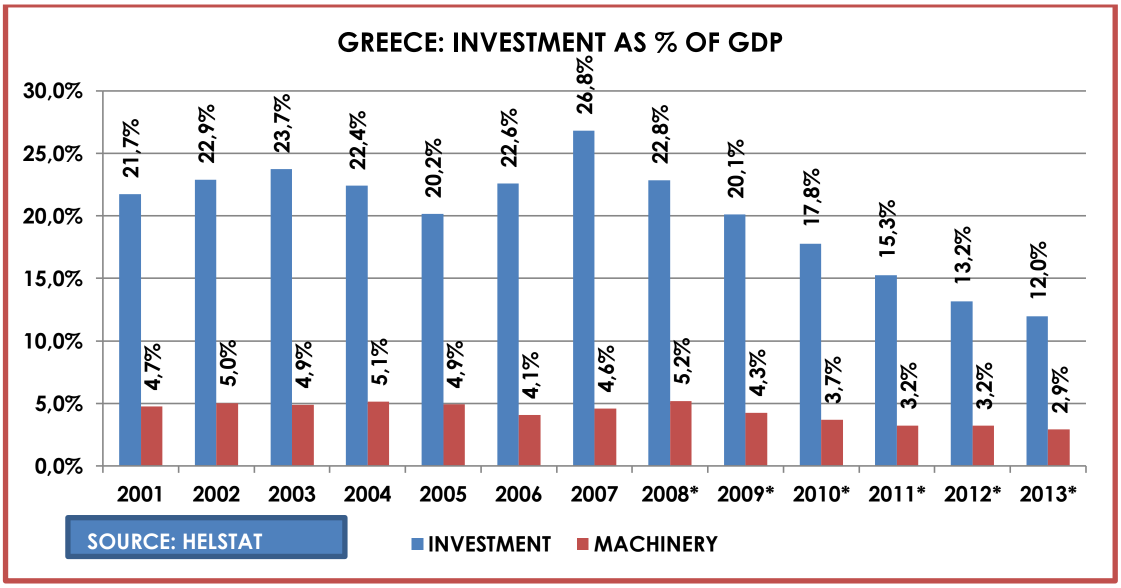
What happened in Greece should not be seen as an isolated case of a failed state. There are general theoretical arguments on whether crises are preventable. The 2008 experience reinforces the view that crises will continue to occur due a combination of inherent to the system deficiencies, tendencies and herd behavior. The causes may change over time but whatever the general direction or governance of a country is crises will continue to hit the system. So Greece is no exception and should not be seen in isolation.

The Lehman collapse unleashed panic in the financial markets. Innovative financial instruments were castigated. All debts came under major scrutiny. So did sovereign debts. Imbalances were seen under a new light. Confidence evaporated. Greece was the weakest link in Europe and the first to collapse. However, economists have to take into account that one of the miracles of the 1990s Ireland has followed on Greece steps as an overextended banking system collapsed (Bank of Ireland). Finland, the other success story of the 1990s is also in dire straits as its overreliance on one sector has led to major imbalances when that particular sector faced a structural crisis (collapse of NOKIA).

There are criticisms about Greece fiddling with the statistics and this may be seen as a particularity of the case. In fact Greece has not done anything different from other European countries regarding compliance with the euro regulations. All the so called "window dressing" practices were first implemented in another European country (mainly but not solely Italy) or other instruments and arrangements were used (Germany) in order to arrive to the same end result i.e. a deficit below 3% upon joining the euro in the 1999-2000 period. The watchdog of the Euro-area on deficit and debt statistics, EUROSTAT, had almost always preauthorized the use of these instruments. From time to time EUROSTAT has changed the rules of the game and that imposed on governments in EU adjustments. One of the major revisions involved the budgetary treatment of the PFIs and leasing which had major consequences for the UK.

Major Structural Weaknesses

Growth for most part of the 1990s and the 2000s was based on two pillars: heavy investment in infrastructure fuelled by the Olympic Games and credit expansion due to the convergence of interest rates. Major infrastructure projects were completed sometimes at a high cost due to the inefficient tendering system. But infrastructure may be a prerequisite for development but not a sufficient condition. The highly regulated economy, the persistence of oligopolies, the small size of the market, the lack of an innovative culture and a weak social capital have all prevented the development of new business activities and the creation of competitive advantages in key sectors. The only new emerging sector of the economy in the past 20 years was aquaculture with Greece being the major exporter in Europe. From the established sectors only tourism retained its vitality without however being able to discard outdated practices and develop new lines of "experience" at the higher end of the market. Therefore, some of the infrastructure projects were not sufficiently exploited and as a result they have not generated any additional viable activity other than that directly associated with their construction and thus their payback periods extend well into the second part of this century. With the benefit of hindsight a more targeted approach should have been adopted. More funds should have been directed to the development of innovation and entrepreneurship.



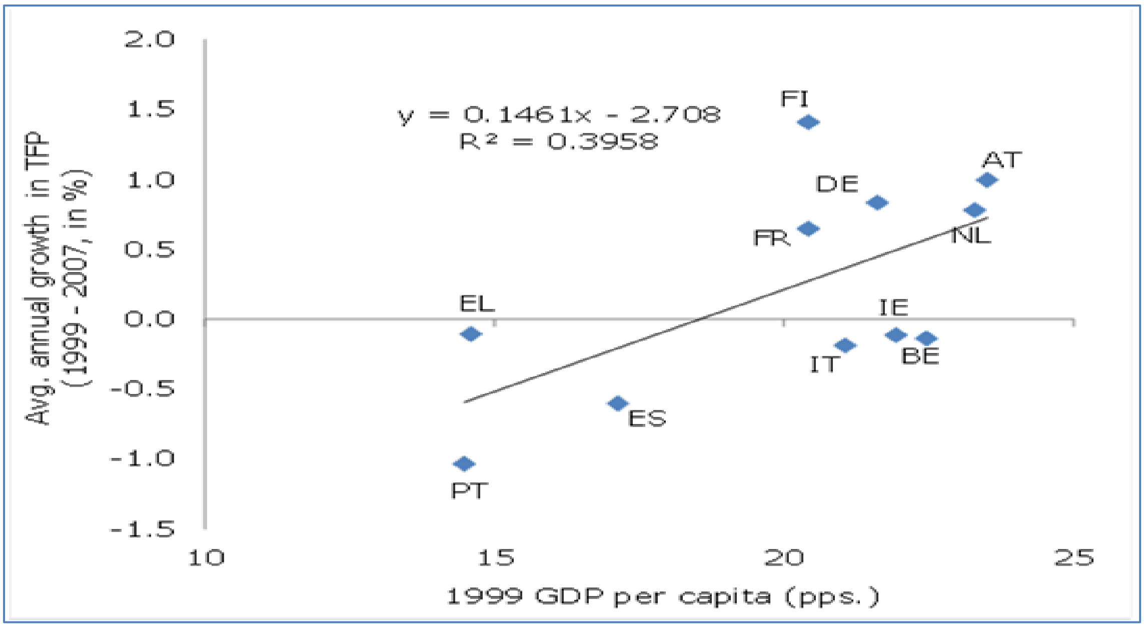
The overall level of investment was high by international standards but the composition is problematic. Investment in machinery was low and as a result the modernization of the productive economy remained modest. R&D spending was low and in some years declining.

A weak reform culture which embraces politicians established business leaders and large segments of the society prevented any radical overhaul of an outdated institutional arrangement. Product markets remained protected and public sector corporations continued to be inefficient and most of them generated huge debts. The union bureaucracies were particularly persistent in their support of the status quo both in terms of pensions and labor relations.

Although Greeks are generally highly educated they lack specific job related skills and the labor force remained poorly trained throughout the period.

As a result of these factors total factor productivity remained low as in other peripheral countries in the Eurozone. In a recent study it is claimed "that between the end of 1990s until the crisis, TFP in catching up states actually declined, resulting in a divergence of catching-up economies from the rest of the euro area Member States"[1].

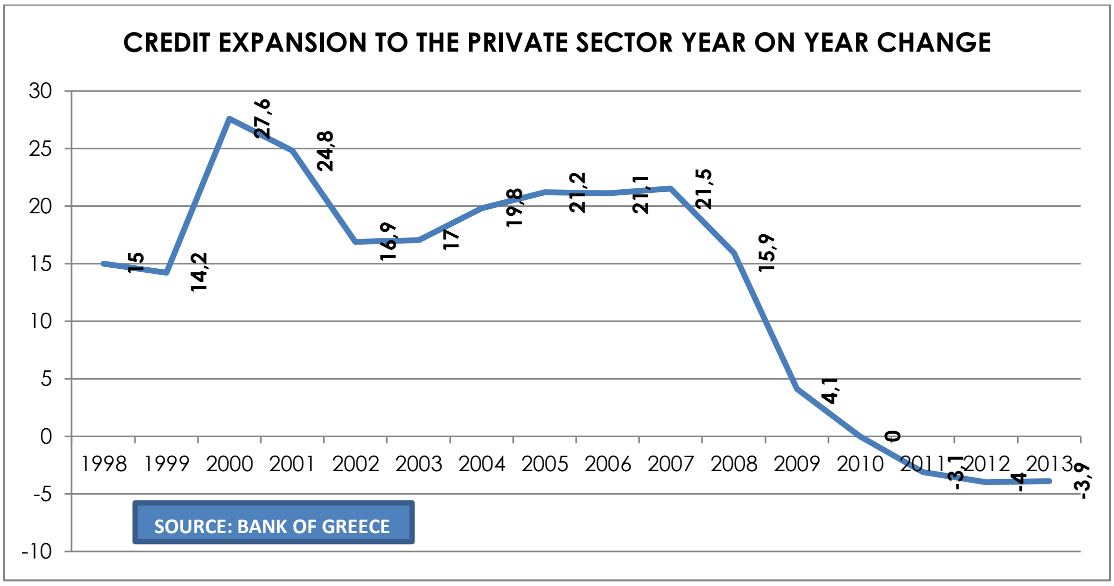
[1] Narcissa Balta and Philipp Mohl (2014) The drivers of total factor productivity in catching-up economies, in European Commission Quarterly Report on the Euro Area, Vol 13,1/2014.



According to the study "the econometric analysis presented in this focus section shows that the TFP divergence between euro area catching-up economies and the rest of the euro area can be partly explained by the following indicators: a weakening of the convergence channel, lower spending on innovation activities such as R&D and ICT, deteriorating government effectiveness and faster population ageing".

Competitiveness deteriorated and Greece position in WEF rankings tumbled from 36th in 2001 (out of 75 countries) to 91st in 2013 (out of 148).

In the meantime credit growth was phenomenal as interest rates converged with the Eurozone average. But loose credit conditions act as a disincentive for change especially for corporations.



However, Greece is not the only one to blame for the crisis. Major imbalances within the Eurozone were not addressed. Germany continued to run surpluses which have not been recycled. As a result imbalances have been exacerbated and the periphery continued to borrow in order to finance current account deficits.

The day after

Austerity has addressed the fiscal and current account imbalances. It helped also in correcting the labor cost competitiveness weakness. However, a return to growth requires more conditions to be fulfilled.

First, Greece should continue with **reforms**, build on existing policy credibility in the markets and regain the confidence required to attract capital for a faster recovery. In this respect we are already seeing an inflow of capital during the first quarter of 2014 of 15 billion euro by funds. The funds are investing in shares and corporate bonds. The next important step is to attract green field investments mainly in tourism but also in export oriented manufacturing. A faster than expected recovery will improve Greece chances will lead to lower unemployment and improve market confidence.

A recent study (Bruegel 2014) commissioned by the European Commission claims that: "In the case of Greece, it is hard to see how the country could exit from its program at the end of this year without some form of further debt relief and an accompanying framework to improve the structural drivers of growth"[2].

The latest statement by Eurogroup is acknowledging the need for more growth initiatives. "Against this background, the Eurogroup welcomes the progress made by the European Commission and the Greek authorities with the preparation of the Partnership Agreement for the European Structural and Investment Funds. In the next seven years, these funds will provide around EUR 19 billion of co-financing transfers for the Greek economy with the aim to create a competitive, dynamic and inclusive economy, driven by entrepreneurship and innovation. Moreover, the Greek government has expressed the ambition to attract and facilitate private investment. In this context, the recently established Institution for Growth will help to pool financial resources from private and public organizations to provide financing to SMEs and for public investment projects[3]".

However, one major concern is the state of the public administration which has been weakened by the policies adopted over the last five years and there is no real initiative to strengthen structures especially those related to the management of the economy. The continuation of the Task Force is a miserable arrangement that has proved inadequate in its assistance. Now is the time to use the available funds in order to create specialized management units in all growth related departments which will be gradually if successful be incorporated into the civil service at a later date.

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[2] Carlos De Sousa, André Sapir, Alessio Terzi and Guntram B. Wolff (2014) The Troika and financial assistance in the euro area: successes and failures, http://www.bruegel.org/publications/publication-detail/publication/815-the-troika-and-financial-assistance-in-the-euro-area-successes-and-failures/

[3] http://eurozone.europa.eu/newsroom/news/2014/05/eurogroup-statement-on-greece/

Second, a **new debt relief** from the official creditors will assist the recovery and stability releasing liquidity for development and reinforcing the view in the markets about the long term viability of the Greek debt. The process of debt relief discussions will start on the 6th of May but is likely to continue until autumn as the creditors will require assurances that Greece will adhere to a rigorous reform program. In the latest Eurogroup meeting a number of milestones have been decided before a full decision is taken, including the completion of the next review in September and the bank stress tests undertaken by the ECB. That points to a decision by the end of the year provided that political developments do not interrupt the process.

Third, **political stability** should be enhanced so that the reform effort is not interrupted. An electoral defeat in the coming European elections may lead to a weakening of the effort reform fatigue and collapse of the coalition government. The opposition is likely to embark on an experimental vaguely described reversal of policy which will lead sooner than later to a head on collision with the creditors especially Germany and EU authorities.

Despite the remarkable progress Greece is not yet out of the woods. The question remains whether this government has the time to lay the foundations for a faster recovery before facing the electorate sometime in 2015. The odds are not in favor of the current coalition, unless middle of the road voters, in the coming European elections, decide to forget grievances and turn up and vote for stability and continuation giving a second chance to the government and Greece.

S. Travlos 6/5/2014