FINANCIAL INSTABILITY, INSTITUTIONS AND REGULATIONS:

THE 2009-2010 GREEK CRISIS

by

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1. Introduction

Greece has been the first member of the EMU to seek IMF support, due to its inability to access the international capital markets at reasonable interest rates. Greece, as well as other Club Med countries, is faced with unmanageable budget deficits and/or debt to GNP ratios. Consequently, Greece fell under the auspices of an ECB-EU-IMF triumvirate to fulfil its financing needs in the foreseeable future and has undergone a severe austerity plan dictated by the" troika". So far, the outcome of this programme has been an unprecedented recession for an EU country and increasing strains on its social cohesion. Evidently, the case of Greece presents the Eurozone with its first real test.

In this short note we shall argue that the imposition of the terms of the memorandum on Greece was not the only road towards fiscal consolidation. We agree that neither outright default nor debt restructuring were viable alternatives for the long run growth of the Greek economy. Instead, we propose a temporary dual currency regime for <u>any</u> of the Club Med countries that face similar problems, not only for its economic benefits but also for the long run viability of the EURO experiment itself. The imposition of the harsh, and often times inefficient, terms of the ECB-EU-IMF memorandum is unnecessary and undesirable both for economic as well as socio-political reasons.

In addition, we pur forward, despite its technical difficulties of implementation, the possible idea of limiting cash transfers as a means to reduce, if not eliminate, corruption in the short run. Moreover, we suggest a series of structural reforms that might guarantee the exit of the Greek economy from recession and assure its long term growth and development. In particular, we regard as necessary conditions the stabilization of expectations, institutional reforms that will safeguard the orderly function of the markets, and, last but not least, investment in and efficient utilisation of the country's human capital.

2. Greek Options

3.1 Default

The default option and, consequently, Greece's exit from the Eurozone is the worst possible scenario for Greece. Besides the political humiliation that default would generate, the contagion effects for the entire Eurozone would be insurmountable.

As one can see from Figure 1, Europe's web of debt is such that no country can be found out without causing a generalized contagion crisis that would precipitate the entire Euro area's chaotic market destabilization. Furthermore, most of Greece's debt is Euro denominated and therefore exit from the Eurozone will not allow for better debt servicing. Plus, any country that defaults usually does not have access to the international capital markets for a long time. For example, Argentina, which defaulted in 2000, does not have an easy access to the capital markets even today. Likewise, Russia, which defaulted in its rouble denominated debt, did not have access the international markets for almost a decade.

Finally, full default will not necessarily ameliorate the painful adjustment costs that the Greek economy needs to undergo. Since it will not have access to the international markets, it will be obliged to spend what it collects from taxes. Thus, the welfare state, social security and other provisions would be decimated. A country that has many continuing problems in foreign affairs (Cypriot issue, Aegean disputes, Skopje issue) cannot afford to compromise its strategic alliances.

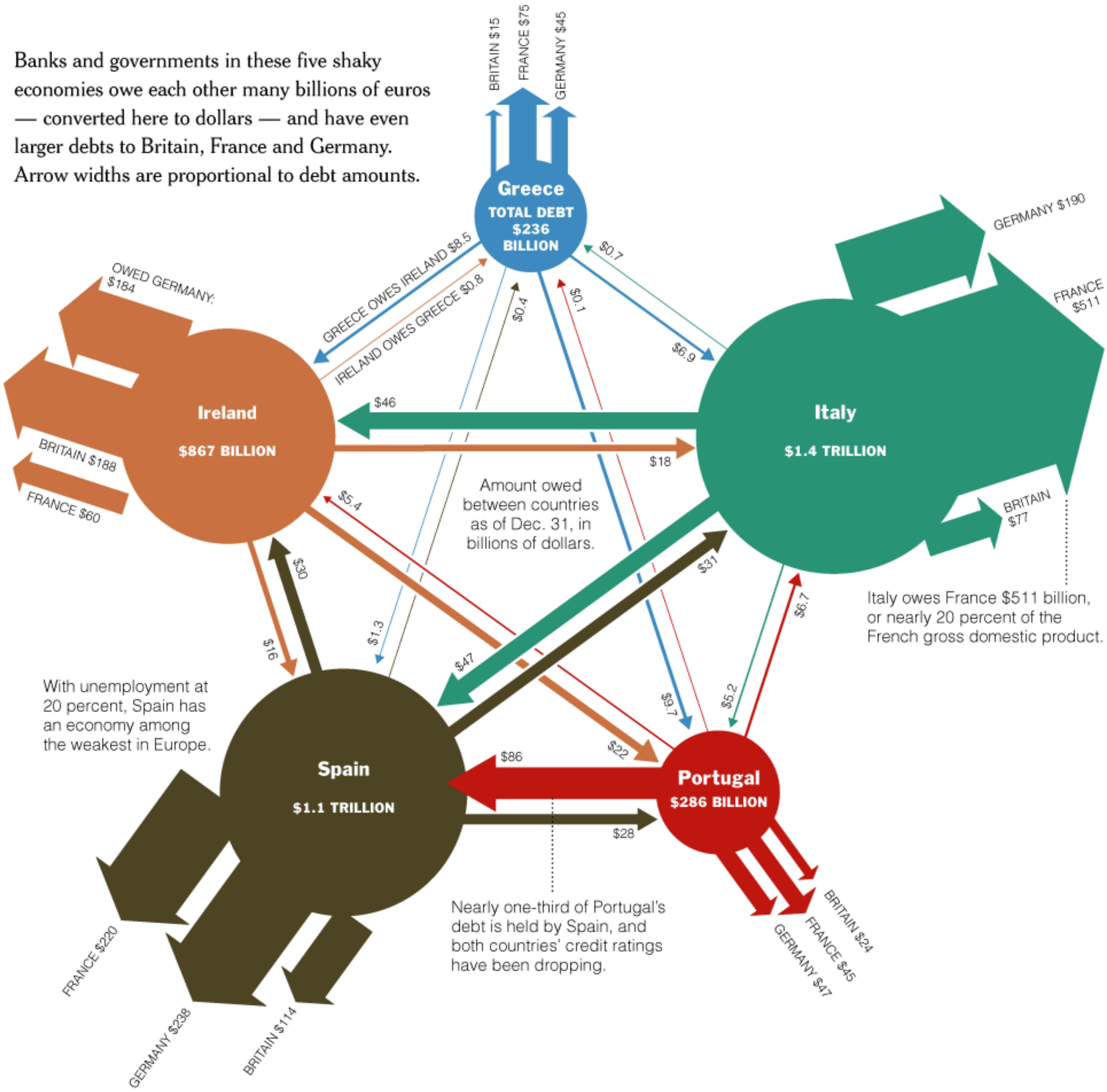


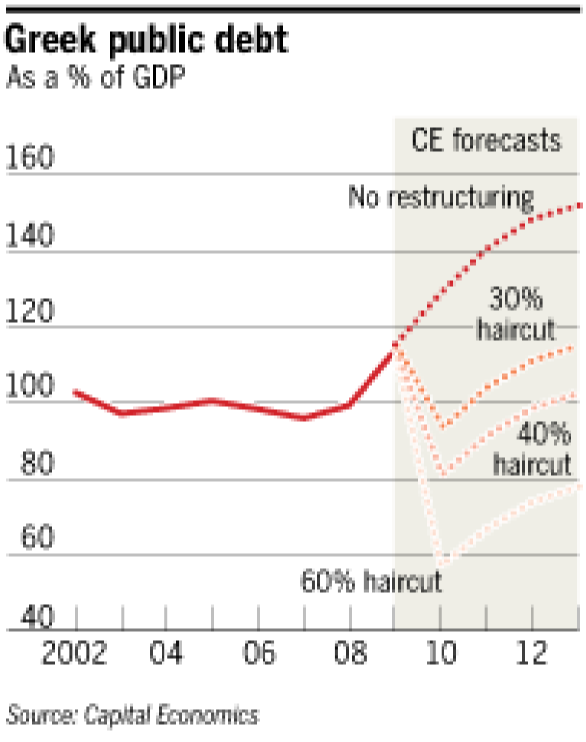
Figure 1

3.2 Debt Restructuring

The €110 bn financial support package announced by the EU and the IMF is associated with strict austerity measures for several years so as to achieve fiscal consolidation. Debt restructuring might occur with an exchange offer, i.e. new bonds of the Hellenic Republic would be offered in exchange for the Republic's existing bonds. Since the first Brady bond transactions in 1990, exchange offers have been the main instrument for sovereign debt restructuring of the emerging markets. However, short-term Treasury bills are excluded to keep markets open for the government's emergency financing needs. Alternatively, new instruments could be used, extending debt maturity as was the case in Uruguay.

The main advantage of debt restructuring is the prevention of full-blown default and the resulting painful adjustment process required by the EU-ECB-IMF memorandum of understanding. Moreover, the implementation of such a scheme could be done more easily than was done in Argentina, since Greek national debt is not diversified very much to retail investors. Finally, Greek debt is governed be Greek law.

However, the disadvantages of such an option are overwhelming. First, more that 30% of the Greek debt is believed to be owned by Greek institutional holders. Hence, potential restructuring will impose significant strains on the already ailing financial sector. The Greek banking system is already under substantial duress, and savings are flowing out of the Greek banks. Therefore, even the prospect of default or debt restructuring can only exacerbate this tendency, currently in the vicinity of 20bn EUROS. Over time, investment will recede and the recession deepen, and may very well culminate in bank runs and the eventual meltdown of Greek banks and contagion to the European counterparts. Second, since European banks are holders of the Greek debt, contagion cannot be ignored, so the EC will not be supportive of such a plan. Third, Greece's debt is denominated in Euros, and unlike the case of Mexico or Philippines, whose debt was held in US dollars, it may have adverse effects on the Euro itself. Finally, even with substantial haircuts at the level of 50% (see figure 2) it would then shoot up again quite soon. In sum, debt restructuring does not solve the debt problem of Greece and yet it may not prevent the inevitable ousting of the country from the international capital markets. Last but not least, the adjustment costs will be borne at the end of the day.



3.3 The Californian solution: Dual Currency

Greece and Portugal have two severe economic problems. These are, first, a fiscal position, deficit and debt ratio verging on the unsustainable and, second, a serious lack of competitiveness (a real exchange rate which is much too high). Italy and Spain may also soon face a similar precarious situation. These countries' membership of the Eurozone constrains the solution to this joint problem.

For example, neither Greece nor any other country in a similar position could sensibly leave the Eurozone, (indeed any sniff of thinking about that would cause an immediate banking crisis). Apart from the immediate effects on wages, prices and interest rates, existing debts are denominated in Euros and any attempt to renege on that would, very likely, result in seizure of Greek assets abroad and expulsion from the Eurozone, in addition to a cessation of European Union net transfers. In this respect Greece is far more constrained than Argentina was.

Similarly, none of the Club Med countries could easily reduce its burdens by defaulting on its public sector debt. Even if they could, somehow, avoid the second-round effect on their domestic financial system, by ring-fencing banks and insurance companies against such default, they could not then borrow. If they could not borrow, they would have to cut spending into line with receipts. But if they had to do this latter anyhow, they could do so without defaulting in the first place. For default would accentuate, not reduce, their current fiscal problems, and precipitate a banking crisis in France and Germany, whose banks are loaded with their assets.

Many Greeks are still hoping for a bailout by richer Eurozone neighbours, under the implicit threat that a Greek enforced withdrawal from the euro or default, even though it would not be in the self-interest of Greece, could cause contagion elsewhere. But that would represent moral hazard in spades.

So, the road of devaluation that was chosen by the UK to fight the crisis is unavailable in a common currency area. On the other hand the Irish or Latvian road of a massive direct reduction in nominal wages and prices is politically unattainable in the Club Med countries and would greatly exacerbate the North-South divide. So what is to be done?

When a subordinate state in a federal monetary union has severe fiscal problems and runs out of money, what does it do? It issues IOUs. Think California or the Argentine provinces before 2000. For example, in Portugal, we could coin a phrase and call such IOUs escudo. Essentially the government passes a decree that states that such escudo IOUs would be acceptable for all internal payments, except tax payments, between Portuguese residents, but not for any external payments between Portuguese residents and foreign residents. All public sector and private sector wage payments shift on to an escudo basis as do interest payments by a Portuguese resident to another resident. Portuguese residents' deposits and borrowing with Portuguese banks shift to an escudo basis; others remain in Euros.

What then would give the escudo value, apart from the accompanying commitment to restore the value of the escudo to parity against the euro, whose credibility would, of course, only be doubted by the most cynical! Note that the government, whose taxes remain paid in euro, would be long in euro, whereas the Portuguese private sector would be long escudo, short euro. So, the government transfers its net long to the central bank and asks the central bank to manage the escudo/euro exchange rate, so that it is stabilised, say at a level that represents a 25 per cent internal devaluation, (the choice of number would need careful calculation). As a by-product the devaluation will enhance the competitiveness of the countries that introduce the mechanism of the dual currency without distorting wealth allocation and sharing the costs of re-establishing fiscal rectitude more equitably. This is in stark contrast with the dictums of the ECB-EU-IMF stabilisation programme. For example, in Greece most of the burden is born by the civil service, pensioners and the low income classess through the increase in VAT. If the central bank does not want to adopt such a dual currency, and under the Maastricht Treaty it could refuse, the Treasury could do this on its own. While managed, the exchange rate should not be pegged. The escudo would be inconvertible, and non-residents would not be allowed to borrow it. After all, this would be but a humble state IOU, though written rather large and not a 'proper' currency; indeed its success would be evident in its disappearance within a defined horizon, say 4 years.

All external monetary relationships, including interest payments, remain unchanged. Internally all price/wage relativities, tax rates, etc, remain unchanged. What changes is the relativity between internal and external payments, (all tourist payments remain in Euros). Portuguese wages and costs fall relative to their prior level; tax rates remain the same, but the enhanced activity raises revenue, and there is a reduction, as measured in Euros, in interest paid to Portuguese residents.

Incidentally, the Greek government has already started honouring its domestic obligations with interest bearing bonds. This is a tantamount to introducing *de facto* a dual currency, modulo the interest promised on these bonds. However, the disorderly and partial introduction of these IOUs will not preserve relative prices and, hence, increase income inequality against the middle and lower income classes. Consequently, consumption and investment demand will fall even further, thus, causing substantial increases in unemployment and the potential to unravel social cohesion.

It would be messy, and a dual currency mechanism is unattractive. But it could work; it has done so before now in other countries and circumstances. It would protect the German banking system, safeguard the basic existence of the euro, and, for the Eurozone countries in danger of default, it might be the least bad option. Indeed, it may very well decrease the gap between the developed North and the less developed South of Europe, as contrasted with the large-scale transfer of structural funds that were allocated and invested in a rather inefficient manner.

4. Should/Can Greece become more like Singapore?

Corruption, and its accompaniment tax evasion, are like a cancer in the Greek national body. Remove it, and recorded income/output and tax revenue would rebound. Corruption and tax evasion are fuelled by (unrecorded) cash transfers, just as cancers are fuelled by certain bodily transfers.

Remove the possibility of (anonymous) cash transfers, and corruption will wither. This is technically possible, requiring the generalised use of electronic e-purses, allowing direct purse to purse fund transfer, with a capacity for records to be sent simultaneously to a central recording station. The technical capacity to do this exists; it was considered by Singapore.

It would be enforced by making holding of all currency notes, whether Euros, dollars, yen, etc., or gold/silver coin, except for certified numismatists, illegal and subject to forfeit, and additional fine in large cases. All entrants to Greece, e.g. tourists, would be given a free e-purse, and required to transform all their currency holdings into e-form; everyone leaving Greece can transform e-money into the cash currency of their choice.

Besides tax evasion and corrupt back-handers, cash is commonly used to pay for human frailties, prostitution and drugs. These should, at the same time, be legalised and taxed, raising further revenue. There would be a trade-off between more tax revenue and becoming a ‘sin-centre’. Since the use of e-purses for such ‘frailty’ purchase would be recorded, sex/drug trafficking by non-residents would be much reduced by threatening to inform home authorities about such behaviour.

There are, of course, numerous objections to this course of action. Let us start with the least pressing:-

1.The old and mentally handicapped would find it more difficult than cash usage. But only initially, and an educational effort would be necessary.

2. The prohibition on cash transfers within Greece, and the recording of e-purse transfers, can be avoided by shifting payments/fund transfers outside Greece. True, but the additional frictions/transfer costs would be considerable.

3. The use of the euro is legal tender in the euro-zone, and this measure would reduce ECB seignorage. Yes, but euro-zone colleague countries appreciate the need for Greece to reform and to raise more tax revenue, without running its economy into the ground. The political good-will should suffice to give Greece a waiver to do this.

Now we move on to the more difficult issues:-

4. The recording of all e-purse transactions, for whatever purpose, would give to those who receive such information enormous potential powers. On the principle of checks and balances to power, the recording site and its IT data base, should be kept outside Greece, e.g. in Switzerland. The staff should be independent (of the Greek government), preferably non-Greek nationals, well paid and their appointment made publicly and transparently by a Committee comprising a range of Greek and foreign notables.

All Greek persons, and Greek institutions, should have an ability to approach the recording centre for information. Yet another independent (and also largely non-Greek) committee, without any access to the data base itself, would then rule whether that request should be allowed. A set of principles indicating when such requests should be accepted would need to be established

5. Even if the provision of information, on e-purse transactions, is held independently of government, with strong safeguards, this would still be a potentially illiberal step. It would not be popular, particularly not so with those currently using cash to fiddle and to reduce their tax base.

The real question is just how serious the Greek nation is about reducing corruption and tax evasion. The technical means to do so can be found. Is the will to do so also there?

5. Structural Reforms

5.1 Stabilization of Expectations

The importance of expectations and market psychology cannot be over-stressed. In fact, arguably the destabilization of market expectations due to misreporting of economic and statistical data to the EU, as well as the sweeping generalizations of the state of the Greek economy by officials as of 2009, was significant. For example, the analogy of the Greek economy to the “Titanic” was preposterous, if not outright insulting. In fact, we cannot recollect a case in recent world financial history that the government had undermined expectation and market psychology so blatantly. In and of itself this incident merits further inquiry. The comparison with the prudent treatment of expectations by the Spanish government documents the point. It is virtually impossible that these officials can restore the credibility about the economic prospects of the country given the assumption that investors are rational.

The **genuine** independence of the statistics authorities is key to the stabilization of expectations. Moreover, the managers of state owned companies and/or government officials that contributed to the profligacy of the state and the widening of the budget deficit **should not** manage the exit strategy form the crisis. Since their credibility has been seriously impaired, it is virtually impossible to convince the markets about their commitment for fiscal consolidation[1]. Indeed, during the transition period towards fiscal consolidation it may be appropriate to dissociate the political cost associated with reform by allowing the presence of non-elected officials with a clear remit from the government to manage the state of the economy.

Finally, transparency and communication of all the obligations that the government has undertaken with the IMF and the EU regarding the bailout package should be immediate and complete. Put differently, the dissemination of information should serve to explain the reasons for the memorandum of understanding, rather than emphasize the political costs associated with its implementation. Otherwise, the adjustment costs will be amplified and potentially foment further social unrest. In other words, transparency and genuine revelation of the relevant information helps to achieve commitment and anchoring of market expectations.

[1] One can connect this to the credibility of Central Banks and the anchoring of inflation expectations

The case of Argentina illuminates how wavering policy measures can destabilize market expectations further and, indeed, deepen the crisis. Apropos, the natural “blame-game”, which occurs in these circumstances, with one political party accusing the other for the economic situation, can only precipitate chaotic market reactions, as recently happened in Hungary with further opportunities for contagion.

5.2 Institutional Reforms

The institutional reforms needed in the case of Greece are well understood and much studied. However, their implementation clearly depends upon the political will of the present government as well as the political repercussions it can, potentially, generate across the entire political spectrum. It is not so much the knowledge of which reforms and how they should be implemented but the consideration of the associated political cost that holds them back. To some extent the unwillingness of every government to carry forward these reforms is a consequence of the clientalistic as well as the paternalistic structure of the Greek political system for the last 35 years.

We shall mention briefly the major medium-term reforms.

5.2.1 Overhaul of the public sector

The inefficiency of the Greek public sector is well known and extends across most of the arms of the state machine. Mismanagement of public funds and unaccountability of distribution are well documented. In addition, its productivity is low relative to other EU countries. It defies any logic that 10% of state subsidies to education are utilized for infrastructure replacement of damaged university and school property. The mere fact that the Greek National Health system is among one of the most expensive in Europe, yet its services are lamentable, is testament to the inefficiencies and ineptitude of the state apparatus. Finally, bureaucratic barriers not only prevent private domestic and foreign investment, but also foment corruption.

5.2.2 Restructuring of Tax collections agencies

Given the intertemporal persistence of tax evasion, it is imperative to overhaul tax collection procedures by providing incentives to the respective agencies to improve their efficiency and productivity, and if necessary to subcontract part of the tax collection activity to the private sector. By most studies, evidence suggests that tax evasion accounts for €20 bn per annum.

5.2.3 Measuring and Registering the "shadow" economy

By most accounts, the shadow economy is over 30% of the Greek GDP. Registering and consequently taxing this substantial part of the economy is of utmost importance, since it constitutes a primary source of corruption as well. This attempt together with the reduction of tax evasion not only can increase the denominator, but also reduce the numerator of the Budget Deficit to GNP and National Debt to GNP. Furthermore, it would arguably send an explicit signal to the international capital markets that fiscal discipline and orderly functioning of the state has finally been established in the Greek economy.

5.2.4 Removal of the oligopolistic tendencies both in the goods and labour markets

There is a plethora of professions (e.g. lawyers, notaries, truck drivers etc.) whereby there exist barriers to entry, and, therefore, competition is seriously impeded. Moreover, Greek labour laws seriously limit labour market flexibility and consequently whenever a recession occurs then "hysteresis" predominates, thus unemployment persists.

As far as the goods markets are concerned, the office of fair trading needs to safeguard the competitive nature of the markets that for most part are oligopolistic. This inevitably underscores the need for supporting and providing incentives for the survival of small and medium sized companies. Heavy corporate taxation of the small and medium sized firms can only ensure that oligopolistic structures consolidate further, and thereby increase the inefficiency of the economy. Last but not least, recapitalization of the banking system is necessary, but that might jeopardise its competitive nature and pre-eminence in the Balkans. Potential explicit or implicit nationalization and/or consolidation of one of the most efficient sectors of the Greek economy could prove to be disastrous in the long-run.

5.2.5 Management of state property

The market value of state property is about €300 bn and yet the return is miniscule. There exist various methods of private/public management that could increase considerably the revenue and, in addition, reduce the level of corruption. State property is fundamentally a public good and its optimal use is warranted.

5.2.6 Privatizations

The Greek Minister of Finance outlined a programme of future privatizations focusing on sales to strategic investors of stakes in transport, water supply and energy sector, gaming and telecommunications.

This privatization plan is based primarily on concessions for strategic investors and arms to reduce the bloated public debt and utilise the private sector efficiency for the Greek citizens' benefit.

However, since the Greek government will maintain the majority of these companies' shares, this will inevitably discourage potential investors. The Ministry of Finance seeks capital to be invested in a distressed economy without granting management rights alongside. The only exception is the National Railway OSE, the priority of the privatization programme as outlined by the Ministry of Transportation; investors will be understandably reluctant to acquire this massively indebted company.

The privatization plan should not be either primarily a fund collecting programme to reduce the budget deficit nor a vehicle for potential investors to acquire public benefits and tax reliefs. The point being that the state needs neither a paternalistic relation with the markets nor a complete dissociation from them. It needs a "clever" association with the private sector to improve its efficiency and productivity.

However, one should be vigilant when it comes to consolidation in the banking industry. Recapitalization is necessary, but also a well diversified industry is needed in the long-run to readily absorb shocks without endangering the ability of the entire banking industry and its intermediation function. The most adverse effect of the Olympic Games was, arguably, the concentration of economic activity into one area, together with its associated urbanisation. Besides economic asphyxiation, the inevitable social problems during a deep recession may constitute a time bomb for the Greek society as a whole. The emergence of ghettos in the centre of Athens and the increased criminality corroborate this argument.

5.2.7 Decentralization of the economic activity

The metropolitan area of Athens constitutes almost half of the entire population, Inevitably, this distorts development away from the Greek periphery and thus renders the entire economy vulnerable to external shocks in Athens.

5.3 Investment in and efficient use of human capital

The cases of Latvia and Estonia are illuminating when the IMF recipe is implemented without being accompanied with appropriate economic policies for growth and development in the economy. The brain drain that ensued in the above countries will inevitably have long-term economic and arguably socio-political consequences. Greece with its inefficient labour markets and lack of meritocracy may suffer a wave of emigration to the rest of the EU. More importantly, this wave of emigration may take the form of skilled human capital that is crucially significant for increasing in the productivity of the Greek economy.

The freedom of movement of human capital within EU will exacerbate the brain drain that less productive economies usually suffer. Given that low skilled immigration primarily occurs via the former Eastern European countries, only the high-skilled labour has a competitive advantage to be employed abroad. Evidence already suggests a dramatic increase of qualified professionals such as doctors that are willing to emigrate, and simultaneously a drop of Greek professionals who repatriate themselves after their postgraduate studies abroad. The previous argument jointly with the pitiful state of higher education may undermine the future economic prospects of the country. Statism, the inflexibility of the labour markets and the suffocating grip of the Greek political parties on the part of the economy that is controlled by the state guarantee cachexia and backwardness.

6. Concluding Remarks

We have attempted to argue that amongst the available options available to Greece presently the least bad option is the introduction of a temporary dual currency mechanism, e-purses and quick structural reforms. The option of default or debt restructuring is to be avoided at any cost. In addition, the continued implementation of the memorandum of understanding between the troika and Greece almost surely will sink the economy even further into recession and endanger its social cohesion. Therefore, a renegotiation of the conditionality terms sooner rather than later.