# On Greek Crisis, Growth, Market-access and Debt-forgiveness

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## Introduction

The recent Greek election reintroduced in the European public debate the question of Greece's future economic direction and place in the euro zone. At the time of writing, events are still unfolding with no clear outcome in sight. The purpose of this article is not to speculate on the likelihood of each possible scenario. Instead, it assesses the optimal course of future economic policy to be pursued in Greece, assuming that its stated objective to remain in the EMU is observed. This paper argues that, for the Greek economy to achieve sustainable high growth rates within the euro area, two inter-related problems must be addressed. Firstly, Greece needs to replace its pre-crisis economic structure with a new model of economic growth aiming at higher competitiveness and technology levels. Secondly, the legacy of Greece's high level of public debt must be tackled in a way that does not create moral hazard, cancelling out the first objective, but facilitates its achievement. Finally, and assuming that the foundation in relation to the objectives listed above has been laid, the question of Greece's re-integration into international financial markets needs to be addressed.

The discussion that follows focuses on these areas. The next section analyses *The causes of the Greek crisis*, an understanding of which is indispensable for determining a credible strategy for its successful resolution. The section entitled *A new growth model for Greece* describes the main features of a new, sustainable growth model for Greece. The subsequent section *(Greece's return to international sovereign bond markets*) puts forward a proposal describing key requirements for Greece's return to the international sovereign bond markets. The section entitled *The debt legacy issue* outlines a debt-forgiveness proposal, relevant not only to Greece, but to all crisis-hit periphery EMU countries, whose main feature is mutual economic benefit for debtors and creditors. The last section offers some concluding remarks.

## The causes of the Greek crisis

The roots of the Greek crisis lie in the 1980s, when Greece followed a traditional, demand-driven Keynesian economic policy. Greece was not the only country that started the 1980s by implementing such policies: most Western European countries followed suit in the 1970s and the early 1980s. These policies, however, proved ineffective in dealing with the high unemployment and inflation rates that followed the oil shocks of the 1970s. That experience showed that the traditional Keynesian approach is not suitable as a credible framework for economic policy, as it does not account for fundamental determinants of macro-performance such as the rational expectations of the private sector and the latter's ability to take optimal economic decisions based on them. As a result, western countries, starting with the United States and the United Kingdom, introduced policies geared towards stabilising inflation and public debt expectations, as well as improving their economies' supply side through reforms aimed at higher competition and productivity. In this context, demand-management policies remain an important stabilisation tool, provided that their use does not result in expectations of high future inflation and unsustainable public/external deficits. However, modern mainstream macroeconomics accepts that demand management policies do not increase long-term growth prospects.

These important changes in global economic thinking did not affect Greek policy in the 1980s. The latter remained anchored to the increasingly outdated traditional Keynesian approach, characterised by a significant expansion of the state's role in the country's economic life and strong monetary and fiscal activism, leading to double-digit inflation rates and a public debt-to-GDP ratio increase from 22.5 percent in 1980 to 94 percent in 1989. At the same time, Greece recorded the lowest

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average growth rate among European Union countries. Overall, the policies followed in the 1980s left a strong legacy of state intervention in micro- and public debt at the macro-level, which the country still has not managed to cast off.

The 1990s were better. The centre-right government of 1990–1993 introduced policies aimed at macro-stabilisation, which were continued by the centre-left governments of 1994–2000. These policies, however, suffered a serious drawback, especially during the second period: Macro-improvement was not accompanied by micro-restructuring, i.e. reforms in the markets of labour, goods and services, as well as an improvement in Greece's institutional performance in key areas such as tax collection and the judicial system. Hence, Greece joined the euro in 2001 without having met the necessary prerequisites set by the theory of optimum currency areas (TOCA). More specifically, the Greek supply side did not have the required degree of flexibility, the Greek business cycle was not synchronised enough with the EMU average and, finally, economic activity remained concentrated in the non-traded sector, which meant that Greece remained a relatively closed economy. At the same time, unsatisfactory institutional performance and excessive bureaucracy/corruption (as measured by metrics such as the World Bank's Ease of Doing Business Index and Transparency International's Corruption Perception Index) continued to pose significant challenges for achieving the necessary restructuring of the Greek supply-side.

Unfortunately, these weaknesses were not addressed in the 2000s, a decade during which Greece returned to policies similar to those of the 1980s. The significant reduction in interest rates following Greece's accession to the euro in 2001 was not used as a platform to reduce the high stock of Greece's public debt. By contrast, it was used to increase the size of the Greek state further, both in terms of public-sector employment and nominal wage increases. This put Greek public debt on an upwards path well before the onset of the global financial crisis in summer 2007. The excessive nominal wage increases given to public sector employees caused similar excessive wage increases in Greece's private sector. As a result, over the period 2001–2009 average nominal labour compensation in Greece grew at a cumulative rate of 47 percent, the highest among EMU member states and almost double the EMU average (27 percent). One third of this increase was given in excess of the sum of productivity growth and inflation (Arghyrou 2014a). At the same time, Greece's natural output deteriorated significantly: the distortions caused by the state's excessive participation in economic life persisted; institutional performance remained unsatisfactory; and the country's human capital deteriorated, as indicated by a declining performance in education quality rankings (e.g. the OECD's PISA Tables, global university rankings etc.). Hence, and in contrast to other European countries of a comparable size (e.g. Ireland, Portugal and the Czech Republic), during a decade that saw an explosion in foreign direct investment, Greece did not attract significant volumes of foreign capital, which would have boosted sustainable employment and technology levels.

Overall, the demand shock caused by increased public expenditure, excessive wage growth and private borrowing (caused by the reduction in nominal and real interest rates following euro-accession), combined with the deterioration in supply conditions resulted in a positive output gap whose cumulative sum over the period 2001–2009 is estimated to be in the range of 40 percent (Arghyrou 2014a). It is often argued that since the beginning of the Greek crisis in 2009, the country's real GDP has fallen by approximately 30 percent, an unprecedented recession in post-war European economic history. This is true and very regrettable. But it is also equally true and regrettable that, prior to the onset of the crisis, Greece experienced a demand bubble of equal size and equally unprecedented duration in European economic history.

From that point of view, the Greek debt crisis and the recession that followed it over 2009–2013 were predictable as an equilibrium phenomenon restoring domestic spending to levels consistent with the country's production capacity. The extent of the recession could have been smaller if serious policy mistakes had not been made (both within Greece and at the union level) during the crisis' crucial early stages (Arghyrou and Tsoukalas 2011). But there is no doubt that the causes of the Greek crisis are primarily internal. The crisis is the result of an outdated, state-centred model of economic growth having run its course. This model could not be maintained any longer within the current globalised, highly-competitive international economic system, especially in an environment of international financial crisis where markets scrutinise each country's economic fundamentals (Arghyrou and Kontonikas 2012). It is even truer to say that this model cannot be restored, no matter how strong the political will of the new Greek government is to regain the state's central position in Greek economic life, or the effort of strong vested interests that have benefited from it (Arghyrou 2014b) to reverse its decline.

### A new growth model for Greece

Before we discuss the key features of a new, sustainable growth model for Greece it is necessary to make a distinction between two different objectives. Firstly, and in relation to the short-run, there is the question of the upwards stabilisation of Greek economic activity to the country's natural GDP. According to the calculations of most international economic organisations, Greek GDP is currently approximately ten percent below its natural level. Closing this negative output gap presupposes an increase in demand which, in turn, is conditional to two factors. Firstly, the creation of positive expectations regarding future economic outcomes, so that consumption and investment decisions are not postponed. Secondly, positive credit growth rates which, consistent with standard monetarist theory, are strongly correlated with output and unemployment in the case of Greece (Arghyrou 2014a). On both fronts significant progress was made during the period June 2012 – September 2014. In recent months, however, increased political uncertainty has reversed this positive trend. This uncertainty must be eliminated without delay, so that the positive growth rate and reduction in unemployment recorded in 2014 can be maintained.

Secondly, there is the question of increasing Greece's natural output, and this is what I mean when I refer to a new sustainable growth model. To that end, the Greek economy must be restructured away from the non-traded and towards the traded sector, to produce tradable goods and services that can compete successfully in domestic and international markets. Greece is not the only country looking to restructure its economy under crisis conditions. In past decades a number of countries have managed to do so. Examples include the UK and Ireland in the 1980s, Sweden, Finland and Canada in the 1990s, Germany and a number of Central Eastern European countries in the 2000s and, more recently, the Baltic countries. The experience of these countries and modern mainstream macroeconomics, suggest that the main features of a successful growth model should include the following characteristics:

Firstly, a continuation of the fiscal adjustment process of 2010–2014 and a further reduction in state intervention in economic activity. Fiscal adjustment should be mainly pursued by reducing expenditure, as this will create fiscal space for a reduction in the taxation imposed on firms and households. Lower taxation incentivises increased labour participation and internal/foreign direct investment, both of which will contribute to upgraded supply conditions, increasing firms' profitability and households' disposable income. It is also important to establish a stable tax system fostering firms' ability to reach optimal, long-term investment decisions. Finally, it is vital to successfully tackle the extensive problem of tax evasion, both for reasons of ensuring fiscal sustainability, as well as to establish a sense of tax fairness among the full range of Greek tax-payers.

Secondly, it is essential to increase the competitiveness of Greek goods and services which, in addition to lower taxation, is also a function of the following factors:

a) Reducing the high mark-ups incorporated in the prices of goods and services through increased market competition. According to the IMF data discussed in Arghyrou (2014a), Greece has almost fully recovered the competitiveness losses sustained in the 2000s when competitiveness is measured using real effective exchange rates (REER) based on unit labour costs (ULC). By contrast, when competitiveness is measured using REER calculated based on consumer price indexes, Greece has recovered only five percent of the cumulative losses sustained following its euro-accession; so that relative to its initial euro-accession value back in 2001, in 2014 the Greek REER was still overvalued by 16 percent. This difference suggests that when it comes to the internal devaluation achieved by Greece over 2010–2014, the contribution of labour income has been much higher than that of monopolistic mark-ups. Therefore, reducing the latter is not only vital for further competitiveness gains but, also, for a fairer distribution of the burden of adjustment. Hence, it is necessary to lift barriers to entry to many hitherto protected sectors; abolish remuneration floors imposed by trade unions for the provision of many services; and further privatisations, as per the recommendations of the report prepared by the OECD (2013).

b) Competitive levels of unit labour costs. This, in turn depends on two conditions:

- Flexible labour market conditions reducing the exposure of employment levels to adverse economic shocks. As suggested by the TOCA, labour market flexibility is a major determinant of a country's competitiveness and contributes to higher employment and income levels within a single currency area. Flexibility is often resisted by trade unions on the basis that it exerts downward pressure on wages and employment. However, existing evidence points in the opposite direction (Di Tella and MacCulloch 2005).

At any event, the introduction of further flexibility in the Greek labour market is unlikely to lead to downward pressure on Greek wages, as the latter's reduction in 2010–2013 seems not only to have fully offset, but actually to have reversed the excessive wage awards of 2001–2009 (Arghyrou 2014a).

• Improvement in the technology level of Greece's aggregate production function. To this end, it is necessary to attract new capital investment and upgrade the country's human capital. Necessary prerequisites for the latter include reducing the still high levels of corruption and bureaucracy, and a significant improvement in the Greek education system.

c) A substantial upgrade in the institutional performance of the Greek state, particularly in functions directly related to attracting domestic and foreign investment projects. In addition to reducing bureaucracy and corruption, key areas in which Greece is lagging well behind its peers are the speedy resolution of legal differences by the Greek judiciary system, the protection of investors' rights and default resolution (Arghyrou 2014a).

**Greece's return to international sovereign bond markets**

Assuming that the current uncertainty regarding Greece's economic direction is resolved and Greece's participation in the EMU is credibly reaffirmed, a key prerequisite for implementing the growth strategy described in the previous section is the country's return to international sovereign bond markets. A major step in that direction was taken in April 2014, when, after excellent preparation, Greece successfully placed a five-year bond issue for three billion euros for the first time since the onset of the crisis in 2009 at an interest rate just below five percent (Mourmouras 2014). However, the political uncertainty created in the second part of 2014 did not allow the outgoing Greek government to pursue its plans for further bond issues. In the wake of the recent Greek election the five-year bond yield returned to 15 percent, while that of ten-year government bonds shot up from six percent in July 2014 to 11 percent in January 2015. Hence, international sovereign bond markets are once again closed to Greece and the process of the latter's re-integration will have to be repeated.

The following three key conclusions can be drawn from Greece's (and other European countries') experience with the sovereign debt crisis (Arghyrou and Kontonikas 2012): firstly, uncertainty regarding future economic developments destabilises national bond markets; secondly, guarantees for the fiscal liabilities of crisis-hit countries stabilises them; and thirdly, markets price national bonds by evaluating country-specific developments and reject political agreements that they deem unsustainable.

On the basis of the above, a credible plan aiming to achieve Greece's return to open-market debt finance should be based on the following points:

Firstly, the plan must be announced as soon as possible and be totally transparent, so as to eliminate uncertainty regarding the conditions of Greece's return to the markets.

Secondly, the plan must be agreed upon by Greece's international partners and should include a precautionary credit facility. These two elements will provide markets with the necessary guarantee of Greek fiscal liabilities for the vital period that will immediately follow Greece's return to open-market debt financing.

Thirdly, Greece's return to markets and the subsequent removal of the precautionary credit facility must take place within a timeframe approved by the markets, otherwise it may be regarded as premature and consequently fail. Therefore the timing must be made conditional to terms exclusively determined by markets. These terms should refer to: (a) the level of Greek government bond yields, which must be defined in such a way so that the condition of public debt sustainability is met on the date of the transition's announcement; and (b) the ability of the Greek banking system to operate without the support of the Euro system's Emergency Lending Assistance (ELA) facility.

Finally, the plan must include automaticity clauses, according to which Greece's transition to market debt financing and, later on, the withdrawal of the precautionary credit line, will happen automatically as soon as the terms described above are met. Without automaticity, uncertainty regarding the conditions of Greece's return to market debt-finance will persist and the market signals relating to Greece's readiness to perform the transition will be diluted.

**The debt legacy issue: a proposal for debt restructuring conditional to reforms**

We end our analysis by discussing an actively debated topic, namely the question of granting Greece debt for-

giveness on the loans provided by its official lenders. Academic debate on the subject is defined by two opposing views. On the one hand, economists like Stiglitz et al. (2015) argue for an outright reduction in Greece's nominal debt obligations, along with the continuation of structural reforms, as a means of kick-starting growth. On the other hand, authors like Gros (2012) argue that Greece does not need debt forgiveness, as the current burden of servicing its debt does not exceed six percent of GDP, a figure lower than Greece's historic average and in line with countries such as Italy and Ireland. Proponents of this view argue that debt forgiveness will create moral hazard blocking necessary reforms. Finally, a third view, advocated by Sinn (2014, 343–53), regards debt forgiveness for Greece and other periphery EMU countries as necessary, but effective in terms of restoring growth only if accompanied by euro-exits. Without the latter debt forgiveness will operate as permanent fiscal transfers that discourage reforms, as per the moral hazard warning.

Based on provisional figures for 2014 and projected figures for 2015, Greece is set to meet the debt sustainability condition in both years (Arghyrou 2014a). This adds weight to the view that debt forgiveness is not necessary. But nevertheless, the high level of Greece's public debt implies that any exogenous external shock can easily put the latter back on an unsustainable path, even assuming an extension of the maturities of Greek public debt of up to 50 years and a lowering of their interest rates to zero (Darvas, Sapir and Wolff 2014). Further lightening of Greece's debt burden could therefore reduce the risk premia associated with Greek investments (capital and financial), thus contributing to higher growth and, in turn, an improvement in debt dynamics. But why should creditor countries agree to offer Greece such assistance? And how does one deal with the moral hazard issue? Economists arguing in favour of further debt relief for Greece have not answered these questions convincingly.[2] Without doing so, calls for granting Greece further debt appear to be asking for something for nothing and, as such, they are unlikely to succeed.

An alternative approach would be to develop a strategy that would apply not only to Greece, but to the whole of the euro zone's periphery countries and would call upon all parties' well-meant self-interest. The basic idea is to make debt forgiveness explicitly conditional to supply-side reforms. This approach has the following important advantages. Firstly, it deals with the moral hazard issue in a positive way, as it incentivises necessary reforms on debt forgiveness. Secondly, by fostering reforms in debtor countries, it creates a positive consumption externality for creditor countries.

The proposal can be analysed within a standard, open economy dynamic stochastic general equilibrium model such as the one by Corsetti and Pesenti (2009). Let us assume two identical symmetric countries, a debtor and a creditor one, where firms determine prices by imposing a monopolistic mark-up on marginal costs and the representative agent consumes, in both countries, a composite basket including domestic and foreign goods. Under flexible prices and constant money supply, structural reforms reducing monopolistic mark-ups in the debtor country increase equilibrium labour input, but also consumption through a reduction in the prices of domestic goods. This is welfare-enhancing for the debtor country because at the initial (pre-reform) equilibrium, the distortions caused by monopolistic mark-ups imply that the representative agent is willing to work more in exchange for higher consumption. At the same time, the reduction in the prices of the debtor-country goods allows the representative agent of the creditor country to increase her consumption without changing the level of her equilibrium labour input. This is a welfare-enhancing gain caused by an increase in the terms of trade of the creditor country. The same result is derived if we assume a positive technology shock in the debtor country following, say, an increase in investment due to lower taxation made possible because of debt forgiveness. Higher technology reduces the debtor-country's marginal costs and, thereby, its goods prices. This increases welfare in the debtor country as the representative agent achieves a higher level of consumption without increasing labour input. At the same time, lower prices for the goods of the debtor country improve the terms of trade of the creditor country, also allowing the latter's representative agent to increase her consumption of debtor-country goods without increasing her labour input.

Overall, in the framework described above, the debtor country does not get something for nothing; it provides creditor countries with a consumption gain in return for debt forgiveness fostering reforms and technology improvement. Therefore, this mutually beneficial framework provides a theoretical basis for developing

[2] A number of observers have argued that creditor countries have an incentive to provide debt relief to Greece because, in the event of a direct conflict, they may have to write-off the full value of their existing loans. This view, however, is mistaken because it assumes that a standoff between Greece and its international creditors is a one-shot game, with symmetrical negative pay-offs and in which only economic considerations come into play. All three assumptions are false and, as a result, Greece cannot rationally impose a debt restructuring programme on its partners without their agreement (Arghyrou 2014c).

a debt-forgiveness programme. Of course, for this to be considered, the proportion of the goods of the debtor country to the consumption basket of the creditor country must be substantial. That is why the proposal outlined above cannot be applied to Greece in isolation, as Greece's contribution to the intra EMU total exports of goods and services is just 0.7 percent and 2.4 percent respectively (2013 Eurostat figures). If, however, we consider the whole of the crisis-hit periphery EMU countries (i.e. Greece, Ireland, Italy, Spain and Portugal) the figure rises to 21.5 percent for goods and 32.3 percent for services. With imports of goods and services accounting for 40.5 percent of the EMU's GDP in 2013, and more than half of this figure representing intra EMU trade, the EMU's average consumption basket includes a proportion of goods and services produced in the crisis-hit countries of around ten percent, a figure that may rise if demand for their goods and services has sufficiently high price elasticity. Overall, a programme of explicitly linking debt forgiveness to structural reforms could be part of the emerging new European economic/financial architecture, along with banking union, further fiscal integration and other institutional reforms in the euro-governance system.

## Concluding remarks

This article discussed a number of topics related to the Greek debt crisis and the prospects for its successful resolution. I argued that the roots of the crisis primarily lie in misguided past internal policies; and for Greece to restore conditions of sustainable economic growth it should continue the process of reform replacing its outdated pre-crisis economic structure with a new one that aims at achieving higher competitiveness and technology levels. Assuming that this condition is in place, and Greece's position within the euro-area is re-affirmed, I outlined the main features of a proposal aimed at resuming Greece's re-integration into international sovereign bond markets. Finally, I put forward a proposal that aims at dealing with the debt-legacy issue, and applies not only to Greece, but to all EMU periphery countries. This makes debt forgiveness explicitly conditional to structural reforms. The element of conditionality addresses the potential moral hazard problem created by debt forgiveness. It also provides a positive consumption externality for debtor countries, incentivising the latter to consider it as an integral part of the emerging new EMU economic and financial architecture.

Despite its undisputed importance, the discussion of Greek debt forgiveness has perhaps assumed dimensions that exceed the latter's ultimate significance for Greece's future economic prosperity. Without eliminating the debt generation process, debt forgiveness (even if granted) will be of temporary assistance only. The key to a permanent resolution of the Greek debt crisis is the development of a successful new growth strategy; and for that to happen, it is vital that Greece persists in its efforts to reform its economy. As I have argued elsewhere (Arghyrou 2014a), this task will be easier for Greece to achieve within the euro area. Past experience shows that the vast majority of beneficial reforms taking place in Greece resulted from the commitments undertaken by the country to secure its participation in the European integration project. Given the existence of strong vested interests standing in the way of reforms and a strong populist streak in Greek politics, Greece's participation in the euro remains the most effective binding modernising force from which, despite the cost of adjustment, the average Greek citizen benefits tremendously.

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