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Give Greece a Chance

The current complicated economic situation in Greece – and the rising political uncertainty that once again accompanies it – has important repercussions for growth, incomes, employment and the banking system in both the short and long term. The new Greek government is trying to perform a balancing act that will on the one hand satisfy its electorate and the more extreme fractions within the Syriza party and on the other hand offer a number of key concessions to the country's European partners. It is thus imperative to carefully select which concessions the EU should make towards the new government.

The causes of the Greek crisis have been widely documented, as has the profligacy of the country's political elite and its preference for closed markets that create rents, which it can then distribute as part of a horse-trading game.[1] A well-documented need to cut waste in the general government and to deregulate the economy, initially included in the list of reforms the official creditors asked Greece to undertake, was pushed forward only slowly and reluctantly. In the end, even though the number of reforms ultimately implemented and the fiscal measures taken sum up to an unprecedented scale, the way these measures were implemented and their timing implied that whatever was done within the context of a rapidly deteriorating political and economic reality was always "too little, too late". During this slow process in which markets anticipated growth-enhancing reforms which never materialised or which were implemented only half-heartedly and with great delays, the financial system of the country was put under extraordinary pressure.

The country was beset by uncertainties with regard to the possible bankruptcy of the state, exit from the euro area, rumours that undeclared moneys would be ferreted out, taxation of deposits, and the need of households and businesses to cover current tax payments and expenses that could no longer be financed by their daily cash flow. Taken together, these uncertainties had a visible impact on the balance sheets of the banks: deposits in domestic financial institutions by households, businesses and the general government in Greece declined by about €100 billion between December 2009 and the summer of 2012 (Figure 1). The gap was filled by the massive assistance offered by the Eurosystem, which was provided swiftly and – given the constraints posed by the behaviour of successive Greek governments and the more conservative voices on the governing board of the European Central Bank – amounted to probably the most effective initiative taken by policy makers during the Greek crisis.

In early 2012, the situation was further exacerbated by political uncertainty following repeated elections; however, the ultimate formation of a coalition government led to the stabilisation of bank deposits starting in early summer 2012. The gradual increase in deposits since then reflected a return of confidence in the safety of the Greek banking system. However, this trend halted in 2013 as talk of a bail-in, given the precedent set in Cyprus, replaced that of an exit from the euro area and as the unreasonably high property taxes, on top of all the other taxes raised in recent years, increasingly forced households to tap into their savings in order to pay them during late 2013 and 2014.[2]

As the balance sheet of financial intermediation in Greece, which by definition is subject to the maturities mismatch between deposits and loans that has always been a salient feature of banking systems, was suffering the maximum pressure from the outflow of deposits, European policy makers imposed the private sector involvement

1 M. Mitsopoulos, T. Pelagidis: Vikings in Greece: Kleptocratic Interest Groups in a Closed, Rent-Seeking Economy, in: The CATO Journal, Vol. 29, No. 3, 2009, pp. 399-416.

2 See T. Pelagidis, M. Mitsopoulos: Greece. From Exit to Recovery?, Brookings Institution Press, Washington DC 2014.

Michael Mitsopoulos, SEV Hellenic Federation of Enterprises, Athens, Greece.

Theodore Pelagidis, The Brookings Institution, Washington DC, USA; and University of Piraeus, Greece.

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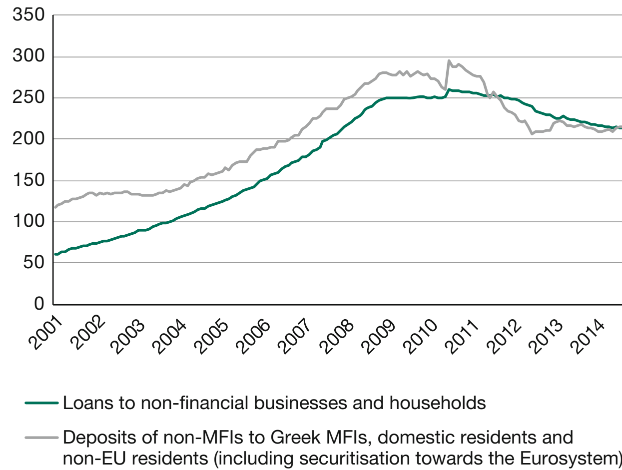
Figure 1
Deposits at Greek main financial institutions, 2001-14
in billions of euros



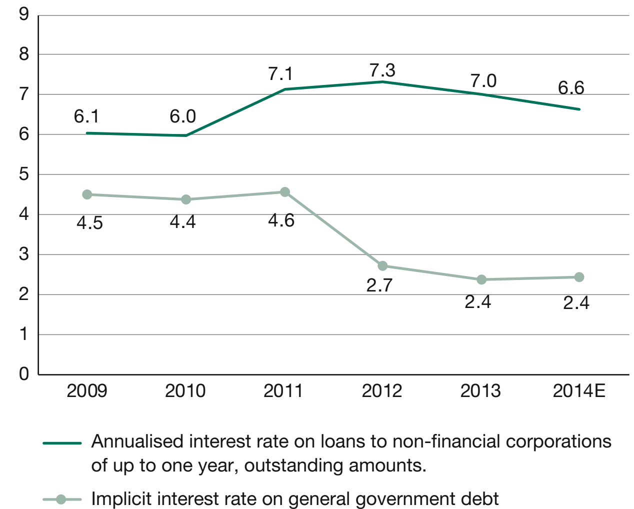
Loans to non-financial businesses and households

Deposits of non-MFIs to Greek MFIs, domestic residents and non-EU residents (including securitisation towards the Eurosystem)

Note: The data do not include covered bonds. The 2010 application of international accounting standards led to a break in the series with the addition of bank transactions with the self-employed.

Source: Bank of Greece.

Figure 2
Interest rates on Greek government debt and corporate loans, 2009-14
in %



Annualised interest rate on loans to non-financial corporations of up to one year, outstanding amounts.

Implicit interest rate on general government debt

Source: AMECO.

(PSI).[3] This haircut on Greek government bonds was implemented in a way that targeted in particular Greek banks and social security funds (via the losses on the bonds they owned), eliminating the capital base of the former. A very slow subsequent process of recapitalising the banks with funds borrowed from Greece's European partners, which were then added to the debt of the Greek government, thus reducing significantly the net debt reduction achieved by the PSI, ensured that the Greek financial system basically was in a state of inactive anticipation from the fall of 2012 till mid-2014.

Given that Greece, with its notoriously slow courts[4] and vague, complex and restrictive laws, does not offer the institutional setting required by the more complicated contracts on which non-bank financing is based, private sector financing is essentially provided by the banks. As the banks were subject to the unprecedented combined strains of significant deposit outflows, the PSI and the slow subsequent management of the fallout from the PSI, a policy nightmare became reality in Greece. Meanwhile, policy makers in Athens and Brussels took little notice or appeared not to care. A fiscal crisis turned into a financial crisis that fed in the real economy.

At the height of the political and financial uncertainty, as talk of a Grexit could be heard in every European office, Greece suffered its largest fall in private sector employment. This placed an even greater burden on the precariously thin balance between the part of the economy that contributes taxes and social security payments to the government budget and the pensioners and public sector employees who anticipate that the government will honour its commitment to pay their pensions and salaries. Even as the official lenders to the Greek government realised that Greece could not afford the high interest rates on the official loans offered to its government, they apparently did not notice that the private sector – i.e. the tax base of the country – was facing financing terms that were incompatible with economic growth (Figure 2). Furthermore, one must take into account that as nominal growth and inflation fell after 2010, the real interest rate increased steadily and significantly, additionally burdening companies as their turnover plummeted.

Even while interest rates in the centre of Europe plummeted to new historic lows, thanks to an environment of ample liquidity provided by the central bank and the intensifying establishment of secular stagnation, money "below the Alps" remained stubbornly expensive, as shown in Fig-

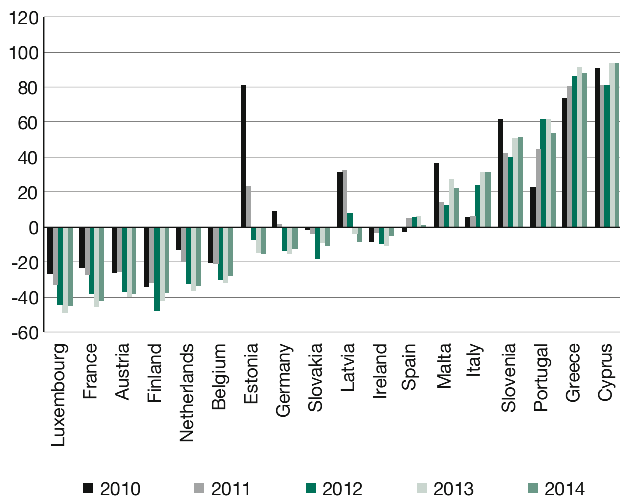
3 The write-down of both the first PSI (July 2011) and the second, larger one (October 2011) imposed severe losses on the holders of these bonds, mainly Greek financial institutions which acquired large amounts of Greek government bonds ahead of the government's request for official assistance in early 2010.

4 See M. Mitsopoulos, T. Pelagidis: Does staffing affect the time to dispose cases in Greek courts?, in: International Review of Law and Economics, Vol. 27, No. 2, 2007, pp. 219-244.

Figure 3

Interest rates on corporate loans, 2010-14

% deviation from the euro area average



Note: Outstanding amounts of loans to non-financial corporations of up to one year. 2014 data through September.

Source: ECB.

ure 3. Owing to such large and persistent differences in the cost of financing, firms in Greece found themselves at a pronounced competitive disadvantage that immediately cancelled out any potential competitiveness gains from the fall of wages, a cornerstone of the "internal devaluation" policy so forcefully advocated by the official lenders.

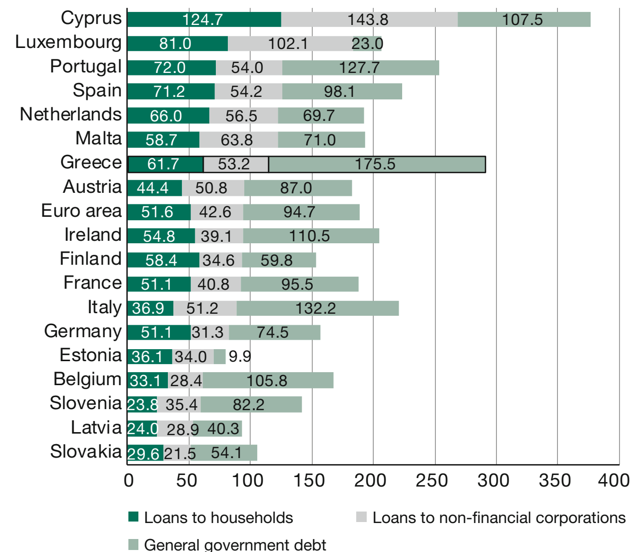
Even now, after a 25 per cent drop in GDP, the Greek private sector does not suffer from excessive debt – its debt-to-GDP ratio is in line with the euro area average, unlike the government debt-to-GDP ratio, of course (see Figure 4).

Nonetheless, by the fall of 2014, the reality of a textbook-style depression, combined with the legacy of the political uncertainty of 2012 and the slow management of the PSI aftermath, became manifest in a different line of the balance sheets of Greek financial institutions. Loans had been paid off by the financially strongest households and companies, bringing the loan-to-deposit ratio back to relative balance and steadily reducing the banks' dependence on the lifeline offered by the Eurosystem; moreover, the capital base of the banks had been repaired by the recapitalisation process and the successful attraction of new private investors. Despite this progress, however, non-performing loans have increased steadily all these years, along with unemployment (Figure 5). As an increasing number of households and companies lost income and revenue during the depression, and as there was no rapid policy initiative to assist them, unemployed citizens and liquidity-constrained companies fell behind in their payments. The process exceeded the natural adjustment

Figure 4

Debt-to-GDP ratios of euro area countries, 2014

in %



Note: Loans by main financial institutions and government debt. Data based on September 2014 open loan amounts and projected 2014 GDP values.

Sources: ECB, AMECO.

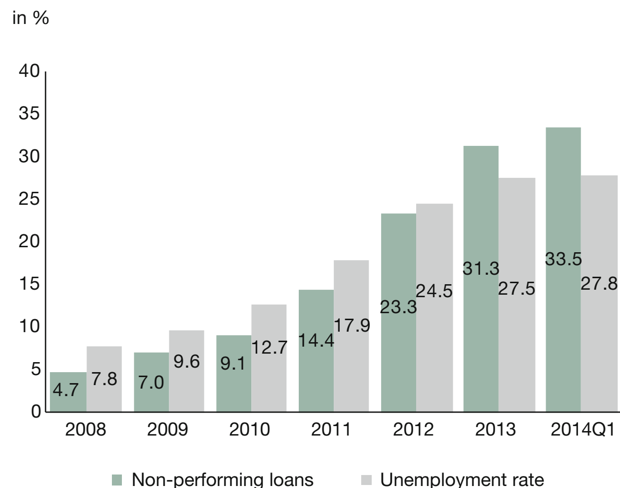
expected from a cut in government waste and from the inevitable closing of e.g. numerous small retail outlets.

While no study exists on the matter, it is safe to say that by now a substantial number of jobs have been lost and numerous companies have failed in spite of being essentially

Figure 5

Non-performing loans and unemployment, Greece

in %



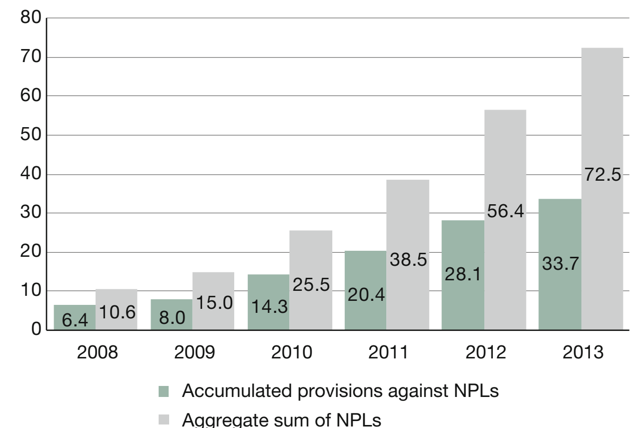
Note: Non-performing loans as a percentage of all loans.

Sources: World Bank, Bank of Greece, Eurostat LFS.

productive; had they been given more acceptable terms of financing, they could have weathered the crisis intact. The gradual normalisation of the balance sheets of Greek banks with respect to their dependence on the Eurosystem lifeline, even while the ratio of non-performing loans crept upwards, documents the transition of the fiscal crisis into a depression. On the other hand, the fact that the fiscal crisis in Greece turned into a depression despite the fact that its financial system had not lent excessively to households and companies implies a number of key differences vis-à-vis other countries where excessive private debt was channelled into non-productive real estate projects. When the bubble burst in Ireland or Spain, there was little value to recover from overpriced and ill-conceived real estate projects. In Greece, contrary to many perceptions, there was no widespread debt-driven real estate bubble or consumer debt overhang. Loans were given mostly to productive companies, and as an unprecedented series of audits of the loan portfolios of Greek banks have demonstrated, they were generally offered on the basis of a sound assessment – at least when political influence did not force loan officers to override their sound judgement, especially with regard to state-controlled banks.

This means that even while non-performing loans now seem to have peaked at about 30 per cent of loan portfolios, corporate non-performing loans constitute the majority of such loans. Conversely, in Ireland and Spain, for example, mortgages were the largest group of non-performing loans. Furthermore, most of the non-performing loans in Greece are backed by some activity that could be restored to health, at least partly, if a successful restructuring is implemented. Finally, given the inflexibility of the related laws, Greek banks have been accumulating these non-performing loans on their balance sheets even while they have been taking generous loan loss provisions against them (Figure 6). In the end, the sum of collateral and provisions should cover any potential losses in most, if not all, of these non-performing loans, should the economy stabilise and recover within a reasonable timeframe and given a well-devised approach towards loan management.

Figure 6
Accumulated provisions and non-performing loans by Greek main financial institutions
in billions of euros



Sources: Computation on Bank of Greece data with World Bank NPL rates.

Post-election developments

In 2004 a centre-right government led by the New Democracy party was elected on promises to reform the state and rationalise public finances. It failed to deliver, but won re-election in 2007 on a promise to achieve the same goals this time. It again failed to deliver. Consequently, despite promising for a third time to enact the same reforms that were now more needed than ever, the party lost the 2009 elections to the centre-left Pasok party, which had promised that “there is plenty of money” to deal with the looming financial impasse. As this money failed to materialise, the government led by George Papandreou asked for an official bailout, which the European partners offered.

After dragging its feet on the agreed reforms and ultimately failing to deliver, the government engineered a haircut in 2012 that devastated the domestic and Cypriot banks as well as the country’s social security funds, which had been required to invest all of their money in government bonds. However, despite the massive damages wrought by the haircut, it was not enough to compensate for the torpor on the reform front, and Greece was forced to ask for a second bailout. The grave mishandling of the process led to the successive downfalls of the Pasok government, an interim government, a caretaker government and finally a coalition government.

The coalition government that took office in late 2012 had taken it upon itself to implement the reforms requested by the official lenders, to achieve an increasing primary surplus in the government budget and to lead the country out of the stringent supervision required by the agreement with the country’s official lenders. Unfortunately, the coalition government was also unable to achieve progress with respect to the reforms that was significant enough to convince markets that Greece had permanently turned the page and that would ensure a rapid increase in employment. By the summer of 2014, a number of politically costly reforms of the pension system were looming ahead of a presidential election, and the representatives of the three institutions that formed the official lenders (the “troika”) were firmly insisting on a number of aggressive (and possibly pointless) reforms in the law for workers’ unions

and strikes. In this setting, the government tried to make a political deal with the EU that would allow it to announce "victory" while only partially fulfilling the troika's to-do list, leaving the politically difficult reforms for later. However, European leaders did not agree. Consequently, the coalition government's approval ratings grew more unfavourable after its failure to present to the electorate even a token victory, and it was branded as a government that never stood up to the demands of the creditors. As the opposition stridently vowed to "renegotiate the debt and end austerity", the government brought forward the presidential elections. These elections failed to elect a president, and the coalition government lost the subsequent elections to a coalition of far-left socialists and far-right nationalists.

While the New Democracy-Pasok coalition government of the 2012-14 period could definitely have been firmer on implementing reforms and more resistant to the "business as usual" attitude with respect to clientelistic politics, a number of reforms were passed. These include a law that accepted numerous recommendations of the wide-ranging OECD Competition Assessment Toolkit,[5] an effort to introduce accountability and on-the-job evaluation in the public sector, a steady improvement of the framework to licence new businesses, and the documentation and mapping of data relating to wages, employment and pensions. The latter reform supported increasingly effective audits of the enforcement of labour laws and initiatives against pension fraud. Of course there was backtracking in some areas, such as on regulations regarding road haulage or a decree requiring the payment of fees to chambers of commerce in addition to the fees paid to a one-stop shop for businesses and the company registry. Still, overall, for the first time since the start of the reform programme, the troika could rely on a number of key ministries to genuinely advance some useful reforms.

But that progress was not enough. By enforcing wage cuts for everybody over a five-year period and promoting "tax anything that moves policies",[6] the troika had increasingly pushed even educated middle-class voters into poverty and to the extremes of the political spectrum. In addition, society was still marked by massive poverty and unemployment (exceeding 25 per cent overall and 50 per cent for the young), the impact of the PSI, the slow recapitalisation of the banks, the omnipresent "Grexit talk" that had suffocated the productive economy and led to the loss of hundreds of thousands of private sector jobs, and a 25 per cent decline in GDP. In addition, a series of hasty and ill-advised tax laws (all of which were sanctioned by the troika) had enraged overtaxed honest taxpayers and property owners.

Figure 7 shows the positive correlation between unemployment and political uncertainty, meaning that when political risk is high, unemployment rises.[7] While it is not the only reason, it certainly contributed to decreasing employment levels. The figure also introduces the cost of money, which is critical to the recovery of the economy. It indicates a positive correlation between interest rates in the private sector and political uncertainty. As indicated above, the current cost of money for the private sector in Greece is incompatible with GDP growth, exports and rising employment.

Under these circumstances, it should have come as no surprise that a radical party of the left, Syriza, took power with a radical nationalistic party, the Independent Greeks, as its coalition partner. Neither should it come as a surprise that those two parties, the Communist Party, Golden Dawn and several other smaller parties combined to garner a majority of the total vote – altogether, 55 per cent of the electorate voted to denounce the so-called austerity programme.

It is somehow ironic that these developments took place as the first green shoots of growth were becoming apparent in the economy. Greece's creditors are again pushing for wage-restricting policies instead of pressing for reforms with an immediate positive impact on growth and employment,[8] while still failing to acknowledge how important an issue the financing of the private sector was for growth. Indeed, there was no meaningful reference to this issue on the list of prior actions required by the official lenders in the summer of 2014. At the same time, the lenders' demands were being becoming more stringent with respect to labour laws and pension reform during each of their meetings with the Greek government.

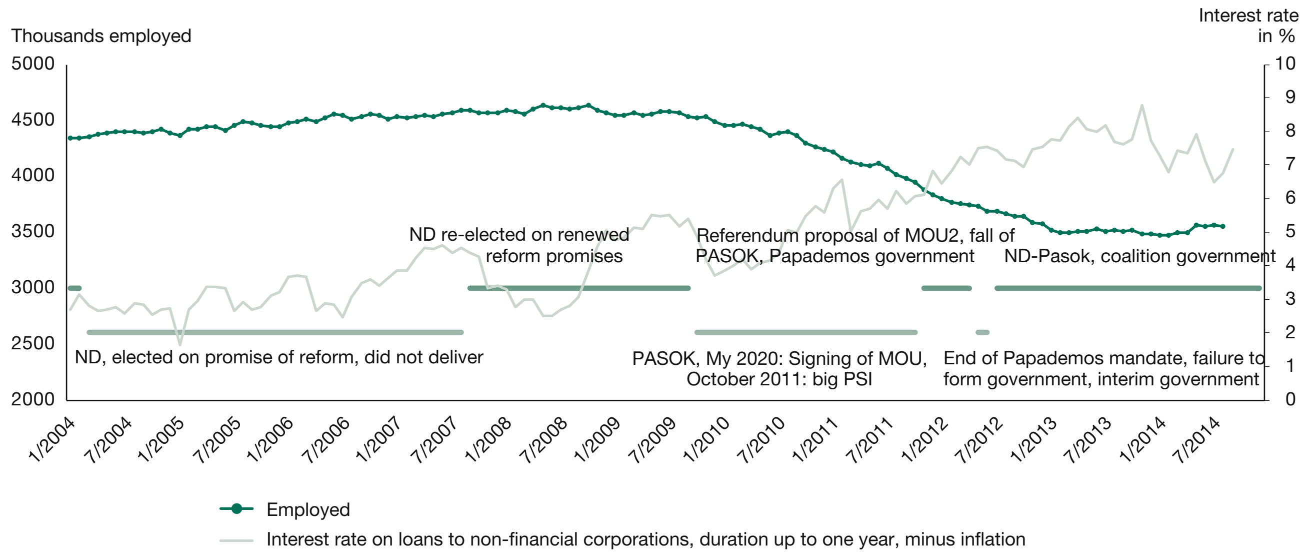
5 OECD Competition Assessment Reviews: Greece, OECD Publishing, 2014.

6 See T. Pelagidis, M. Mitsopoulos: Greece: From Exit . . . , op. cit.

7 R. Bachmann, S. Elstner, E.R. Sims: Uncertainty and Economic Activity: Evidence from Business Survey Data, in: American Economic Journal: Macroeconomics, American Economic Association, Vol. 5, No. 2, April 2013, pp. 217-249; Uncertainty and unemployment, 23 January 2013, The Economist; The cloud of uncertainty Dithering in the dark. Quantifying the effect of political uncertainty on the global economy, 16 June 2012, The Economist; Assessing the impact of uncertainty on consumption and investment, European Commission: Quarterly report on the euro area, Vol. 12, No. 2, June 2013.

8 D. Furceri, A. Mourougane: How do Institutions Affect Structural Unemployment in Times of Crises?, OECD Economics Department Working Papers, No. 730, 2009; A. Bassanini, R. Duval: Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions, OECD Economics Department Working Papers, No. 486, 2006; G. Nicoletti, S. Scarpetta: Product Market Reforms and Employment in OECD Countries, OECD Economics Department Working Papers, No. 472, 2005.

Figure 7
Employment, real cost of money and political uncertainty



Sources: ECB, Eurostat.

Today's complicated situation – and the rising political uncertainty that once again accompanies it – has important repercussions for growth, incomes, employment and the banking system in both the short- and long-term. The creditors currently seem content to clash with Syriza, as a Syriza defeat might be instructive as an lesson for all of the euro area. In the meantime, political risk is killing the economy, and nobody – yet again – seems to care. On the other hand, an appeasement policy towards Syriza is clearly impeded by the assertions of some members of the new government that they intend to stop and reverse reforms and then start a socialist transformation of both Greece and Europe with the help of e.g. Podemos in Spain and Die Linke in Germany.

Conclusion: How to give Greece a chance?

The new Greek government is currently trying to perform a balancing act that will on the one hand satisfy its electorate and the more extreme fractions within the Syriza party and on the other hand offer a number of key concessions to the country's European partners. For example, the government's demands for a hard haircut of the officially held debt have been dropped, and its demands to end the memorandum of agreement and abolish the troika have been softened into demands to change their content and composition respectively.

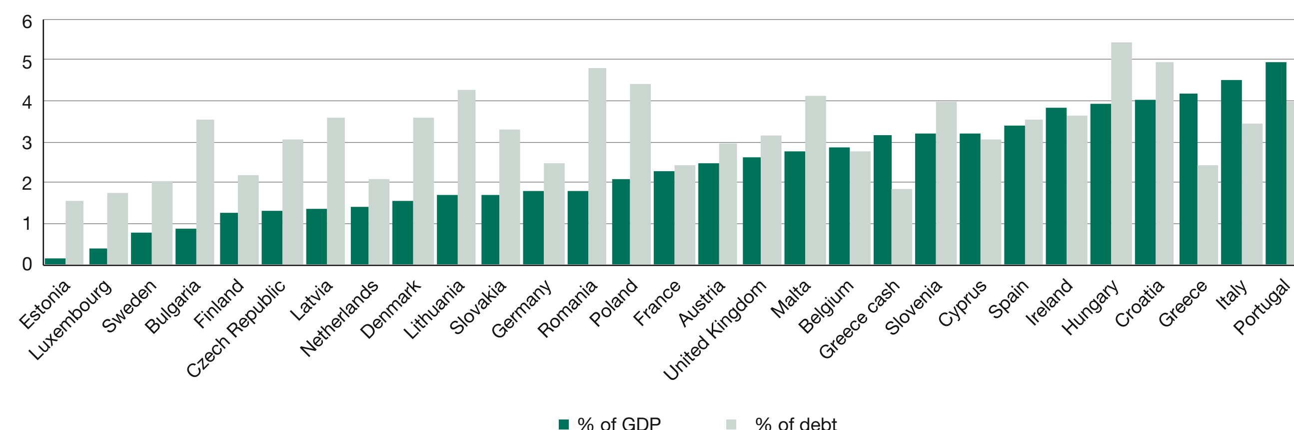
For their part, the European partners insist on a list of actions that have to be advanced and a commitment to abstain from unilateral initiatives to roll back the reforms that have already been implemented, in particular labour market reforms and fiscal targets.

More importantly, as the political uncertainty has pushed the economy and the job market into decline again and as the pre-election rhetoric has led many taxpayers to postpone payments, the country's already precarious public finances have once again been put under strain. The commitment of the new government to secure primary surpluses of 1.5 per cent of GDP have not been well received by the European partners, since the money required to merely service the interest payments until 2024, when the interest payment derogation of the European Financial Stability Facility loan expires, currently exceeds three per cent of Greek GDP.

This is, however, the main point where the Syriza government is right. Unlike, say, Italy or Spain, where interest payments are also high (see Figure 8), the vast majority of Greek government debt has been held outside the country since the PSI. Therefore, these interest payments will flow out of the country, meaning that they will be a constant drain of liquidity from an economy in which the lack of access to finance currently constitutes the largest hurdle for economic growth and job creation.

The European partners need to accept the fact that the new Greek government is the political fallout from the mistakes made in the adjustment programme, regard-

Figure 8
Interest on public debt



Sources: AMECO, Greek government budget.

less of who is to blame for these failures. Inevitably, the Syriza government's agenda will be at odds with a number of the reforms already implemented and the reforms still demanded by the adjustment programme. This does not mean, though, that there can be no common ground in some areas. In order to find this common ground, it is imperative to carefully select which concessions the European partners should make towards the new government.

Given the importance of liquidity for the private sector, the primary surplus, and the liquidity drain it implies, should be one such concession. As the European partners are accountable to their electorates, a reduction in the interest payments will be politically impossible at this point of time, as will be a hard haircut, which the Greek government has already agreed to drop from its list of demands. What can be achieved given all these constraints is a deal that will both secure the ownership of these sums to the lenders, while at the same time ensuring that the liquidity stays in the country. For example, the official lenders can deposit the interest payments in Greek banks, a portion of which may as a matter of fact be used to buy Greek government bonds – a solution that can be calibrated to the primary surplus level ultimately agreed upon.

Such a deal needs to be accompanied by a firm insistence to advance those reforms that can secure growth, even while allowing room for the government to implement key aspects of its social agenda. Identifying useful and mutually acceptable initiatives to improve the business environment is crucial.[9] An effective approach against tax evasion and corruption has been announced by the new government, but a firm proposal with respect to excessive social security payments for private sector employees has not been announced. Privatisations may become concessions, wherein the state retains ownership but the private sector efficiently manages key infrastructure items like ports or airports for the benefit of exporters and tourists. Basic pensions may be secured even while overly generous early retirement schemes are finally rationalised. Aspects of the labour market regulation that will not threaten employment may be altered in order to alleviate extreme social hardship. Laws to deal with households and companies that cannot currently service their obligations must allow debt restructuring to take place in a constructive manner that addresses tangible needs while avoiding obvious moral hazard.

Some of these issues are not limited only to Greek politics. For example, the definition of a non-performing loan is currently the same in Greece and in Germany. This rule could be calibrated to account for the fact that falling behind on payments in Greece today relates to a very different reality than it does, say, in Germany. Also, there is no known example of effectively dealing with an economic depression without a determined plan of public investments in useful projects. The European plan to support investment could be calibrated in the case of Greece in order to achieve the best results. Last but not least, "Grexit" talk and fears about the fungibility of money in Greece have to be permanently laid to rest.[10]

9 For example, high energy prices have been mentioned as a problem by the new government. See M. Mitsopoulos, T. Pelagidis: Why did the forceful internal devaluation fail to kick-start an export led growth in Greece?, in: Challenge, Vol. 57, No. 6, 2014, pp. 85-102.

10 Stability and Prosperity in Monetary Union, Speech by Mario Draghi, President of the European Central Bank, at the University of Helsinki, 27 November 2014.