George A Provopoulos: The Greek economic crisis and the euro

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the Scholars Association of the Alexander S Onassis Public Benefit Foundation International Conference, Athens, 21 June 2010.

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It is a great pleasure to take part in this conference on the “Financial and Economic Crisis” organised by the Scholars Association of the Onassis Foundation. Aristotle Onassis, the originator of this foundation, was, among other things, a creative thinker and a philanthropist. He arrived in Greece in the early 1920s as a refugee and, through wise decision-making and hard work, became an internationally-prominent entrepreneur.

However, he never forgot his origins and, as exemplified by this foundation, passed on to future generations the ability to advance scientific and artistic knowledge.

My presentation will deal with the origins of the present crisis in Europe and the lessons of the crisis for Europe’s single currency, the euro. Greece is at the epicentre of the crisis; my presentation will, therefore, highlight the Greek roots of the crisis.

The origins

To provide some perspective to the present situation, let us look back just a year. At that time, conferences were being held throughout Europe celebrating the tenth anniversary of the euro. Academic economists were writing articles speculating that the euro was poised to challenge the U.S. dollar as the leading international currency. What a difference a year makes! Today, analysts are writing about a possible break-up of the euro zone, a notion that, as I will explain, is absurd. Meanwhile, the euro has fallen sharply against the dollar since the beginning of this year, and the speculation that the euro will soon replace the dollar as the leading international currency has subsided.

How did we come so far so fast? How could Greece, a country with only about 2 ½ per cent of euro-area GDP, cause tremors of such magnitude that they have shaken the foundations of Europe’s single currency? To answer these questions, we need to consider the basis upon which monetary union in Europe has been built.

The inception of the euro zone on January 1, 1999 marked a world premiere. For the first time in history, sovereign states – eleven at that time – abandoned their own national currencies in favor of a common currency, the euro, and surrendered their monetary-policy sovereignty to a newly-created, supranational institution, the European Central Bank. All previous monetary unions among sovereign states involved at least an element of coercion. For example, the fifteen countries that comprised the former Soviet Union had no choice but to use the rouble as their currency. In the case of the euro zone, in contrast, the members willingly gave up their national currencies for the euro.

The euro was adopted because a monetary union confers a number of important advantages on participating countries.

- For countries with histories of high inflation, such as Greece, it lowers inflation expectations and, therefore, nominal interest rates. With lower nominal interest rates, the cost of servicing public-sector debt is reduced, facilitating fiscal adjustment and freeing resources for other uses.
- With low inflation, economic horizons lengthen, encouraging borrowing and lending at longer maturities. The lengthening of horizons and the reduction in interest rates stimulate private investment and risk-taking, fostering economic growth.

- For all participating countries, it does away with the possibility of competitive devaluations, thus boosting intra-area trade.
- It introduces a common measure of value across countries, increasing price transparency and, therefore, competition.
- It eliminates the costs of converting currencies, thereby facilitating trade and investment.
- It eliminates exchange-rate fluctuations among participating countries, thereby reducing risk premia.
- It eliminates the need of foreign-exchange reserves for intra-area transactions, thereby reducing the cost of conducting business.

These advantages of a common currency exist so long as the central bank of the monetary union delivers price stability and is credible. In the case of the euro zone, the ECB quickly established its anti-inflation credentials and became credible.

So much for the benefits of the euro. What about the costs? In joining the euro area, a country gives up two potential tools to adjust the domestic economy in the event of a country-specific shock. First, it loses the ability to set its own domestic monetary policy. Second, it loses the ability to change the nominal exchange rate of its currency. To compensate for the loss of these two potential tools, a country should possess the following:

- relatively-low fiscal imbalances, so that fiscal policy can be used counter-cyclically in case a country-specific shock occurs, and
- flexible labour and product markets, so that the country can be competitive without having to rely on changes in the exchange rate of a domestic currency to achieve and/or maintain competitiveness.

The need of low fiscal imbalances and flexible labour and product markets is especially important in the euro area. Unlike the United States, for example, the euro area does not have a central fiscal authority that can redistribute fiscal resources from a low-unemployment region to a high-unemployment region to reduce the effects of asymmetric shocks. Moreover, because of language and cultural differences among European countries, labour is less mobile among euro-area countries than it is among regions of the United States. For these reasons, it is all-the-more important to have adjustment mechanisms in place at the *national* level in the euro zone. Low fiscal imbalances and flexible product and labour markets provide mechanisms to smooth the adjustment to shocks.

Against the backdrop of these advantages and constraints of a common currency, let me describe some salient features of the Greek economy since it became the twelfth member of the euro area on January 1, 2001.

The Greek economy: 2001–2009

Entry into the euro area provided Greece with an improved, stability-oriented environment. The ECB was – and is – the guardian of monetary stability. The Stability and Growth Pact was supposed to help ensure fiscal discipline. These changes in the economic environment were crucial benefits for a country that had experienced persistent budget deficits, and inflation rates that were at double-digit levels from the early-1980s until the mid-1990s.

Not surprisingly, the new environment, especially the low interest rates, contributed to robust real growth rates. From 2001 through 2008, real GDP rose by an average of 3.9 per cent per year – the second-highest growth rate (after Ireland) in the euro zone – underpinned by household spending for consumption, housing investment, and business investment. Inflation, which averaged almost ten per cent in the decade prior to euro area entry, averaged only 3.4 per cent over the period 2001 through 2008.

On the surface, therefore, the Greek economy appeared to have entered a new era marked by robust growth and low inflation. Beneath the surface, however, long-standing problems were continuing.

- Fiscal policy was pro-cyclical throughout the period 2001 through 2009, with deficits consistently exceeding the Stability Pact's limit of 3 per cent by wide margins and no durable progress in lowering the public debt-to-GDP ratio.
- Expansionary fiscal policy was mainly expenditure-driven, leading to a rise in the share of government spending; in the three years, 2006 to 2009, the share of government spending increased from 43 per cent of GDP to 50 per cent.
- Although inflation in Greece during 2001 through 2009 was low by the *country's* historical standards, inflation was relatively-high by *euro-area* standards. Inflation was, on average, more than one percentage point higher per year than in the rest of the euro area. Wage increases, adjusted for productivity changes, also exceeded the average increases in the rest of the euro area.
- With both prices and wages growing at relatively high rates, competitiveness declined. In the period 2001 through 2009, competitiveness, as measured by consumer prices, declined by almost twenty per cent; as measured by unit labour costs, competitiveness declined by over 25 per cent.
- With relatively high real growth rates and declining competitiveness, the current-account deficit, which already had topped 7 per cent of GDP in 2001, rose to about 14 ½ per cent of GDP in both 2007 and 2008.

The large and growing fiscal and external imbalances were not sustainable. On various occasions, including the publication of our *Annual Reports* and our bi-annual *Monetary Policy Reports*, during the past several years the Bank of Greece has stressed the unsustainability of these imbalances and the need of urgent policy adjustments. Unfortunately, our calls for actions were not heeded. The present financial crisis is the outcome of the lack of policy responses to the imbalances.

The crisis in the Greek economy

The present financial crisis marks a third stage of the crisis that erupted in August 2007, following the collapse of the US subprime mortgage market, and escalated with the demise of Lehman's Brothers thirteen months later. Yet, during the first two years of the global financial crisis, the Greek economy escaped relatively unscathed. There were few, if any, forewarnings that the Greek economy would become the object of the speculators' attention. The spread between Greek and German sovereign ten-year bonds, a key indicator of relative risk as perceived by credit markets, hovered around 130 basis points during the period August through October 2009. Earlier in the year, at the height of the Lehman's phase of the crisis, spreads had climbed to over 300 basis points. That earlier widening of spreads occurred despite the fact that markets were expecting a fiscal deficit of less than 4 per cent of GDP and a debt-to-GDP level of only about 96 per cent of GDP, figures that would be repeatedly revised upward during the remainder of the year.

In the fall of 2009, two developments combined to disrupt the relative tranquility of Greek financial markets. First, in October the newly-elected Greek government announced that the 2009 fiscal deficit would be 12.7 per cent of GDP, more than double the previous government's projection. In turn, the 12.7 per cent figure would undergo further upward revisions, bringing it up to 13.6 per cent of GDP. Second, in November 2009 Dubai World, the conglomerate owned by the government of the Gulf emirate, asked creditors for a six-month debt standstill. That news rattled financial markets around the world and led to a sharp increase in risk aversion.

In light of the rapid and sharp worsening of the fiscal situation in Greece, financial markets and rating agencies turned their attention to the sustainability of Greece's fiscal and external imbalances. The previously-held notion that membership in the euro area would provide an impenetrable barrier against risk was shaken. It became clear that, while such membership provides protection against exchange-rate risk, it cannot provide protection against credit risk.

The subsequent course of events has made global headlines, so I do not need to dwell on details. Allow me, however, to highlight the following.

- First, in contrast to the origins of initial stage of the global crisis in August 2007, which involved a crisis in the U.S. banking sector that spilled over to the real economy, in Greece the problems posed by both the fiscal and external imbalances spilled over to the real economy. The Greek banking sector has had sound fundamentals as reflected, for example, in high capital-adequacy and Tier 1 ratios.
- Second, the crisis in Greece contributed to widening spreads in other euro-area countries judged to have large fiscal and/or external imbalances. The spread of the crisis to other parts of a geographical area represents a continuation of a process observed in other recent crises, including those in Latin America in 1994/95 and in Asia in 1997/98.
- Third, the commitment by the Greek government to reduce the fiscal deficit from last year's 13.6 per cent of GDP to 8 per cent this year and below 3 per cent in 2013, and the 110-billion euro support package agreed between the Greek government and the European Commission, the ECB, and the IMF, are unprecedented in terms of magnitudes. I have no doubt that the government will take whatever measures are needed to attain its fiscal objectives to ensure fiscal sustainability. It will, however, take some time to convince the markets of the government's determination to achieve those goals. Decades of fiscal mismanagement and faulty fiscal reporting have caused the markets to adopt Saint Thomas's dictum: to see is to believe.
- Fourth, I am also confident that the government will implement the structural reforms and privatisations that are part of the support package. These are needed to reduce excessive bureaucracy and rigidities in the labour, product and service markets that discourage investments in high-value added sectors.

Allow me to say a few words about Greece's debt situation. Some market analysts are of the opinion that Greece's debt dynamics are unsustainable. They are wrong. They overlook the fact that a crucial element underlying the evolution of the debt-to-GDP ratio is the denominator of that ratio, which includes the growth of real output. In this connection, the combination of factors comprising the support program – that is, fiscal discipline, the liberalisation of markets, privatisations, and measures to increase the efficiency of the bureaucracy – will contribute to confidence, decrease the size of the public sector, reduce interest-rate spreads, and boost competitiveness and economic growth. In turn, higher growth, along with declining fiscal deficits, will cause a reversal of the rise in the debt-to-GDP ratio observed in recent years. Moreover, fiscal discipline will add to saving, thereby supporting private investment and growth potential. These effects may not be visible immediately, but they will materialize and will revitalise the Greek economy.

Some lessons

What, then, are the lessons that can be drawn from the crisis? In my view, some of the key lessons concern the limits to the use of fiscal policy and are as follows.

- First, the view that fiscal policy can be used in a flexible way to smooth the effects of shocks in a monetary union has been shown to be overly simplistic. As the case of Greece illustrates, the systematic use of fiscal policy in the past can lead to problems of debt-sustainability, constraining the *current* use of fiscal policy. I need to mention that fiscal expansions in many countries with relatively-low debt levels in the immediate aftermath of the Lehman crisis were successful in lessening the impact of the dislocation in their real economies. Even in those countries, however, there is now a need for decisive actions to achieve a lasting and credible consolidation of public finances.

- Second, rather than smoothing the adjustment to shocks, in Greece pro-cyclical fiscal policy has been the major *source* of shocks. It has led to an increase in the size of the government sector in the economy, increasing bureaucratic inefficiency and crowding-out the traded-goods sector of the economy.
- Third, fiscal transfers in the face of *permanent* shocks can have the perverse effect of locking resources in place, and, thereby, preventing necessary adjustment. The remedy for non-competitive areas of the economy is *not* to channel even-larger amounts of government spending into those areas but rather to introduce structural reforms that improve overall competitiveness by allowing the transfer of resources to the more-dynamic sectors of the economy.
- Fourth, as we have seen, a country with large fiscal imbalances that is in a monetary union can create negative spillover effects, raising interest rates and increasing the cost of debt servicing for other members of the union. The credibility of the ECB provides the potential of a low interest-rate environment, which can foster higher growth and employment throughout the euro area. However, as recent events have underlined, monetary policy needs to be complemented by responsible fiscal policy to maintain such a low-interest-rate environment.

Conclusions

As I mentioned at the outset, the euro area has the capacity to deliver enormous advantages to its members. To benefit fully from those advantages requires fiscal responsibility and open and flexible markets. It also requires a governance structure that will ensure that the Stability and Growth Pact fulfills its role as a key pillar of the euro area.

The support package agreed between the Greek government and the European Commission, the ECB and the IMF provides the government with a unique opportunity to adjust the economy. The package provides a blueprint for sharply reducing fiscal imbalances and for the undertaking of structural reforms. It will set-off positive growth dynamics that will, among other things, lower the debt-to-GDP ratio. The growth potential of the Greek economy is enormous. It is my firm belief that the present crisis will prove to be the catalyst that will reshape the economy, making Greece a competitive and prosperous member of the euro zone. It is also my firm belief that it will not be long before articles again start talking about the euro's strong position as an international currency.

Ladies and gentlemen, thank you for your attention.