The root-causes of the Greek sovereign debt crisis

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Introduction

- To better understand the current sovereign debt crisis in Greece, a longer view is warranted

- The 20 year period 1989-2009 is bounded by two major fiscal crises in Greece:
  - the 1989-1993 crisis, and
  - the ongoing crisis.

  In both crises deficits exceeded 15,0% of GDP.

- In between, Greece entered the Economic and Monetary Union and adopted the Euro

- To facilitate discussion the 20 year period will be divided into two parts:
  - the 1989-1999 period, and
  - the 2000-2009 period.

1989-1999: securing EMU membership

The 1989-1993 sub-period:

- Macroeconomic developments
  - Weak economic activity (1.2% average growth)
  - Very high inflation (16.8% annual average)
  - Very high real and nominal interest rates
  - Low fixed investment (1.5% annual average)

- Fiscal developments
  - Very high general government deficits (13.6% of GDP average)
    - The 1990 deficit reached 15.9% of GDP
  - Primary deficit averaged 4.3% of GDP
  - Fast accumulation of debt
    - Debt ratio increased from 69.0% of GDP in 1989 to 110.1% of GDP in 1993
    - Other reasons for debt accumulation
  - Very high interest payments
    - From 6.8% of GDP in 1989 to 11.4% of GDP in 1993

TABLE 1
Selected Macroeconomic Indicators
(annual average rate)

	1989-1993	1994-1999	2000-2004	2005-2009
Real GDP growth	1,2	2,8	4,5	2,0
Fixed investment growth	1,5	6,1	6,9	-1,9
Inflation (CPI)	16,8	6,8	3,3	3,0
General Government deficit (% of GDP)	-13,6	-7,0	-5,2 (-5,7)*	-8,3 (-9,1)*
Primary Deficit (-) or Surplus (+) (% of GDP)	-4,3	4,0	0,6 (0,7)*	-2,9 (-3,2)*
Total general government expenditure (% of GDP)	48,7	48,7	45,5 (49,9)*	47,5 (52,1)*
Total general government revenue (% of GDP)	35,1	41,5	40,3 (44,2)*	39,1 (42,7)*
General Government debt (% of GDP)	73,7	109,0	101,0 (110,7)*	109,7 (120,2)*
Current Account deficit (% of GDP)	-2,6	-3,0	-6,8	-11,9

*Numbers in parentheses show respective values prior to the GDP revision by 9,6%, which covers only the period 2000-2009.

Diagram 1
Real GDP growth

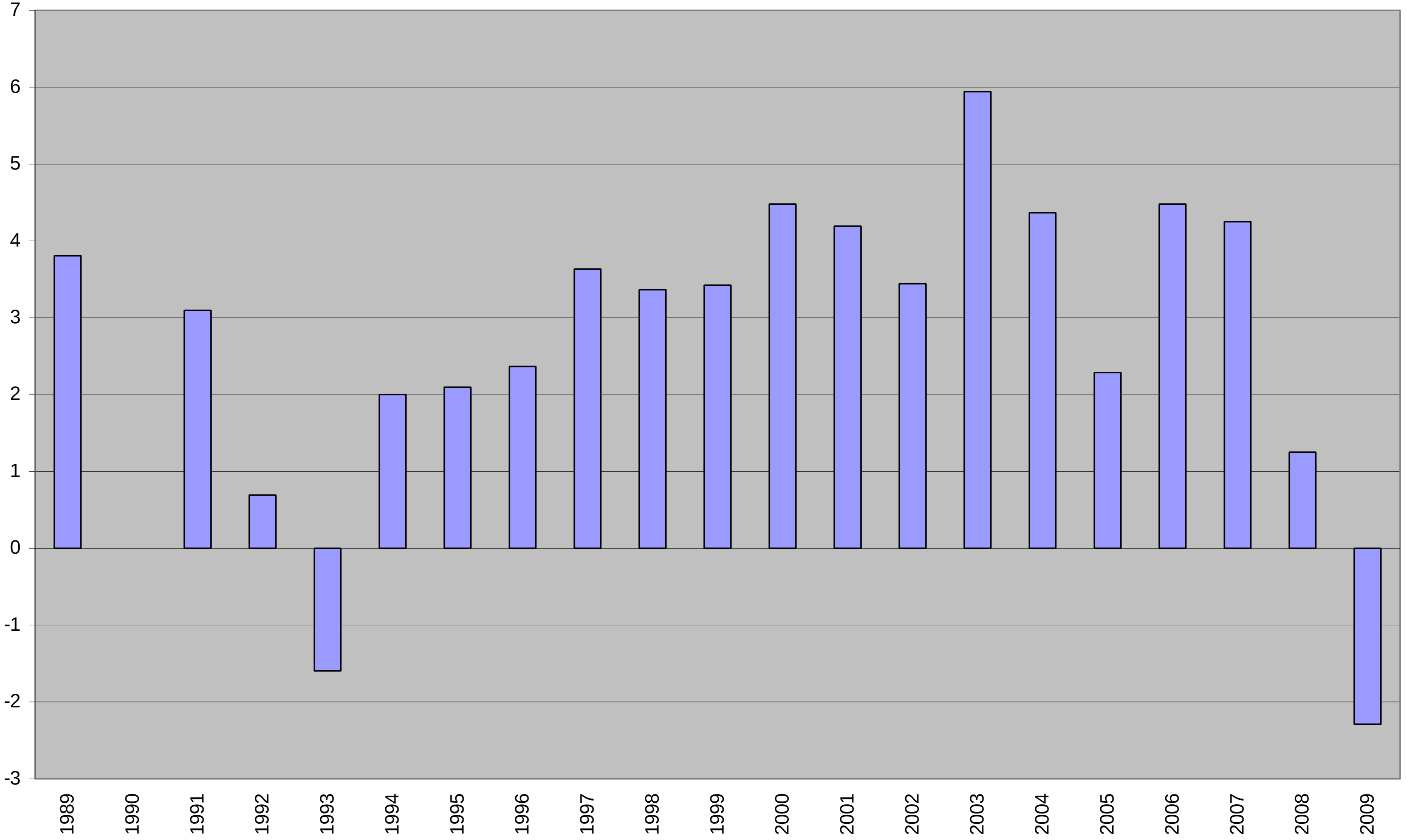
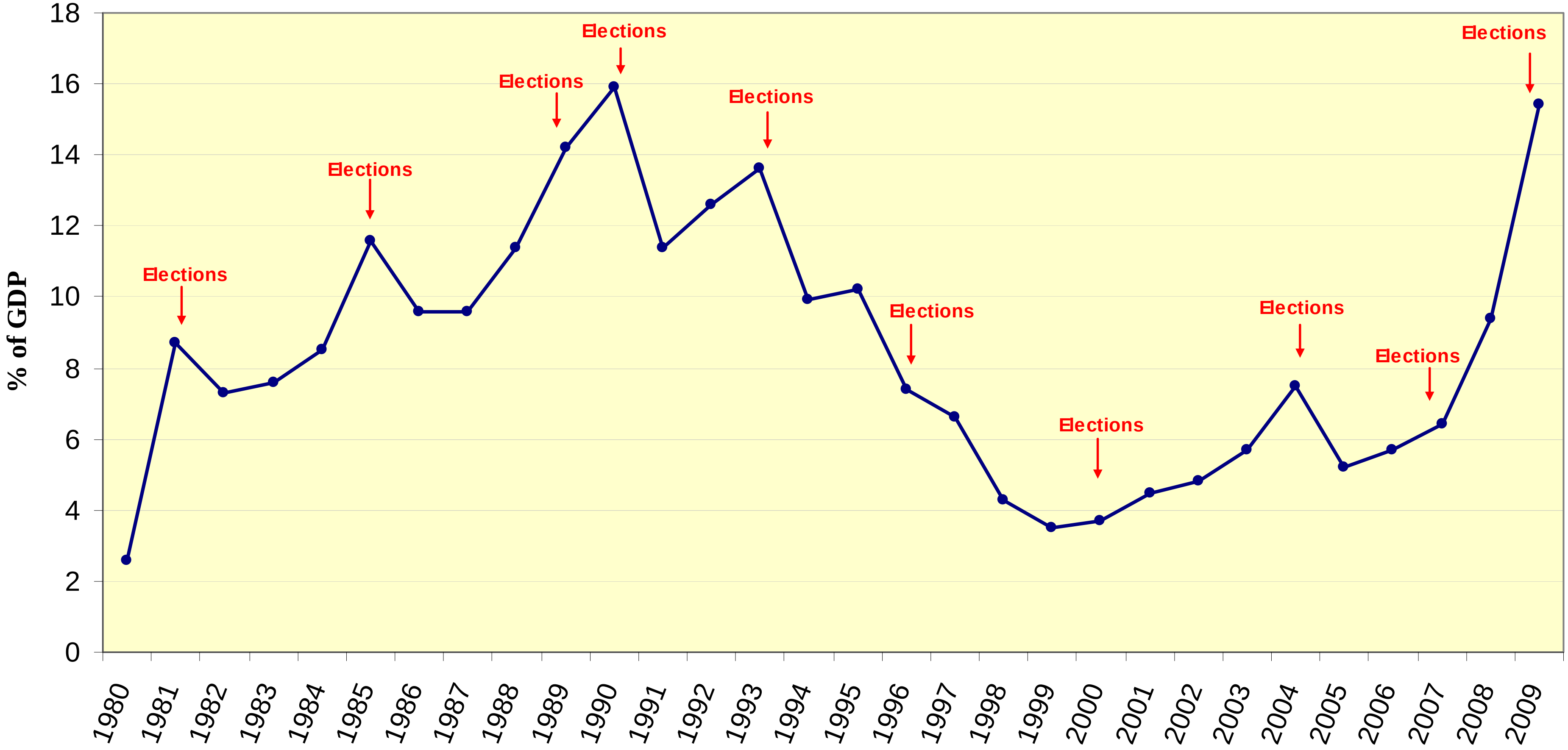


Diagram 2
Elections and General Government Deficit
(% of GDP)



Securing EMU membership: 1994-1999

- Fiscal developments
  - Tight fiscal policy stance
  - General government deficit declined from 13.6% in 1993 to 1.8% in 1999 (although later it was revised to 3.4%)
  - Consolidation exceeded 10 p.p. of GDP
  - Primary surpluses appeared, reaching 4.9% in 1999.
  - Interest payments reached an alarming 12.7% of GDP in 1995 and then declined to 8.4% of GDP in 1999

- The "quality" of fiscal consolidation
  - Composition of fiscal consolidation was lacking
  - Based on tax increases and falling interest payments
  - Primary expenditure increased from 36.2% (1994) to 39.9% of GDP (1999)
  - Personnel expenditure rising every year, exceeding budget targets
  - 1995-1998: the central government wage bill increased by 70.7%
  - Pensioner's Solidarity Allowance was introduced in 1997

Diagram 3
Primary General Government Deficit (% of GDP)

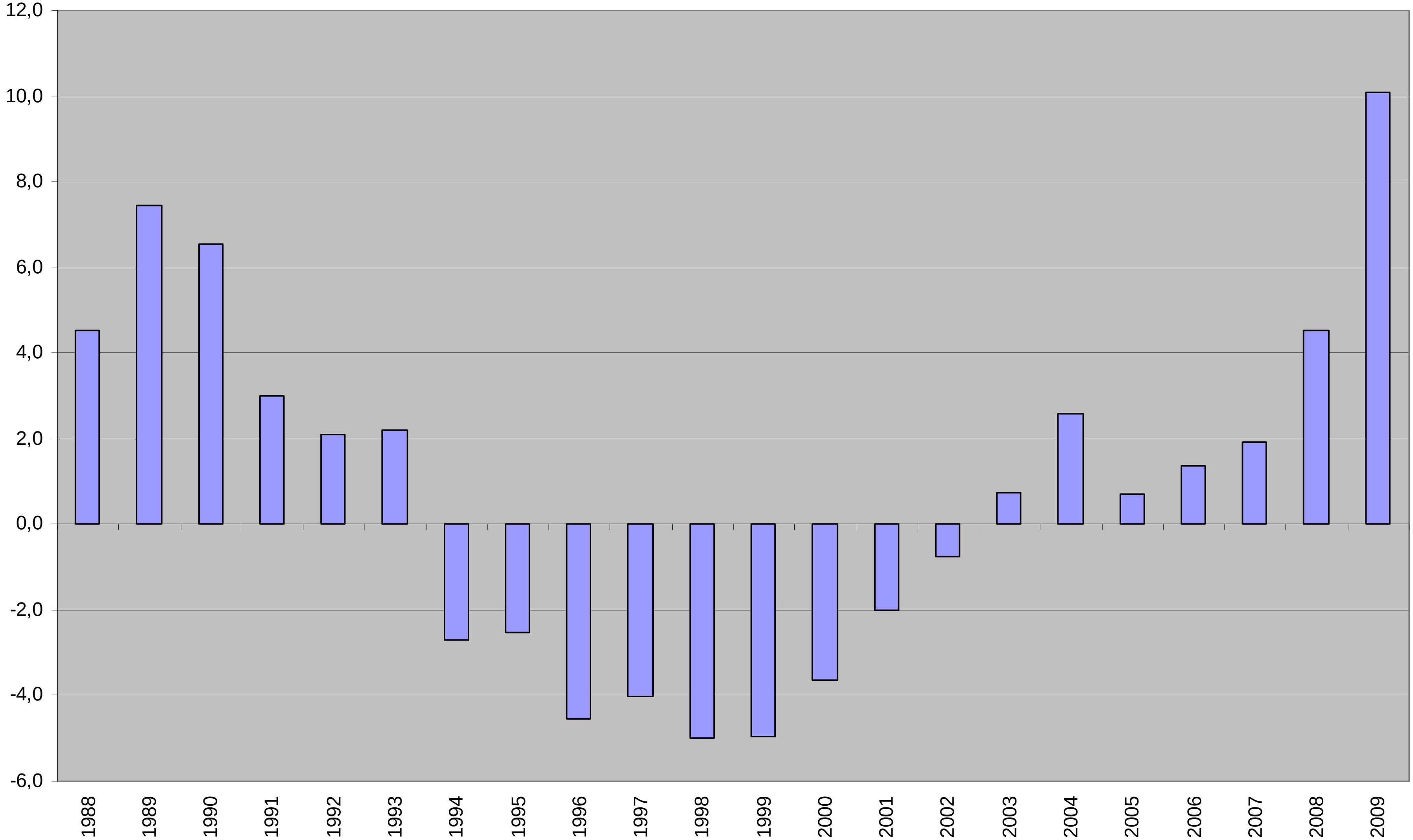
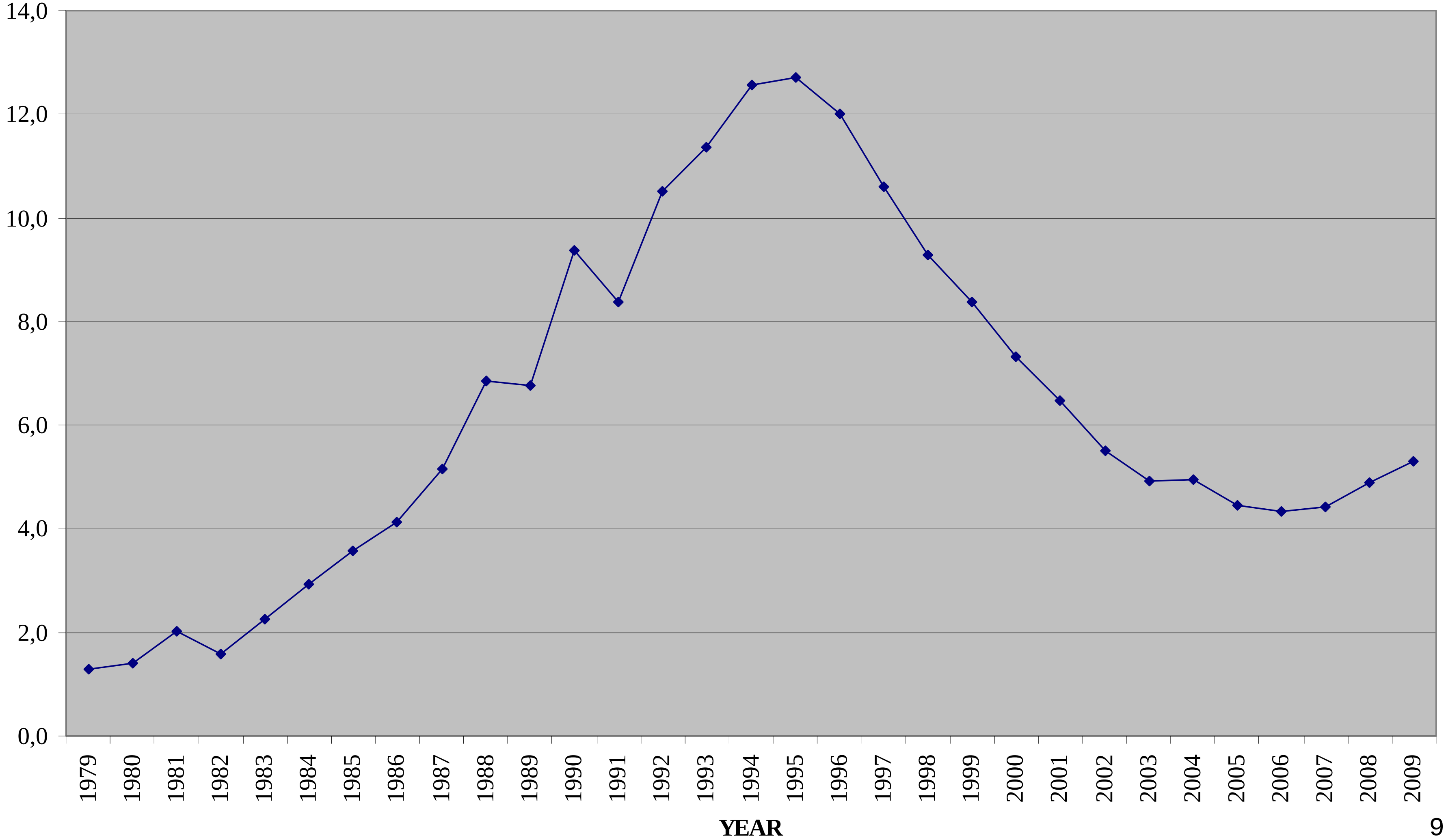


Diagram 4
General Government interest payments
(EDP definition)
(% of GDP)

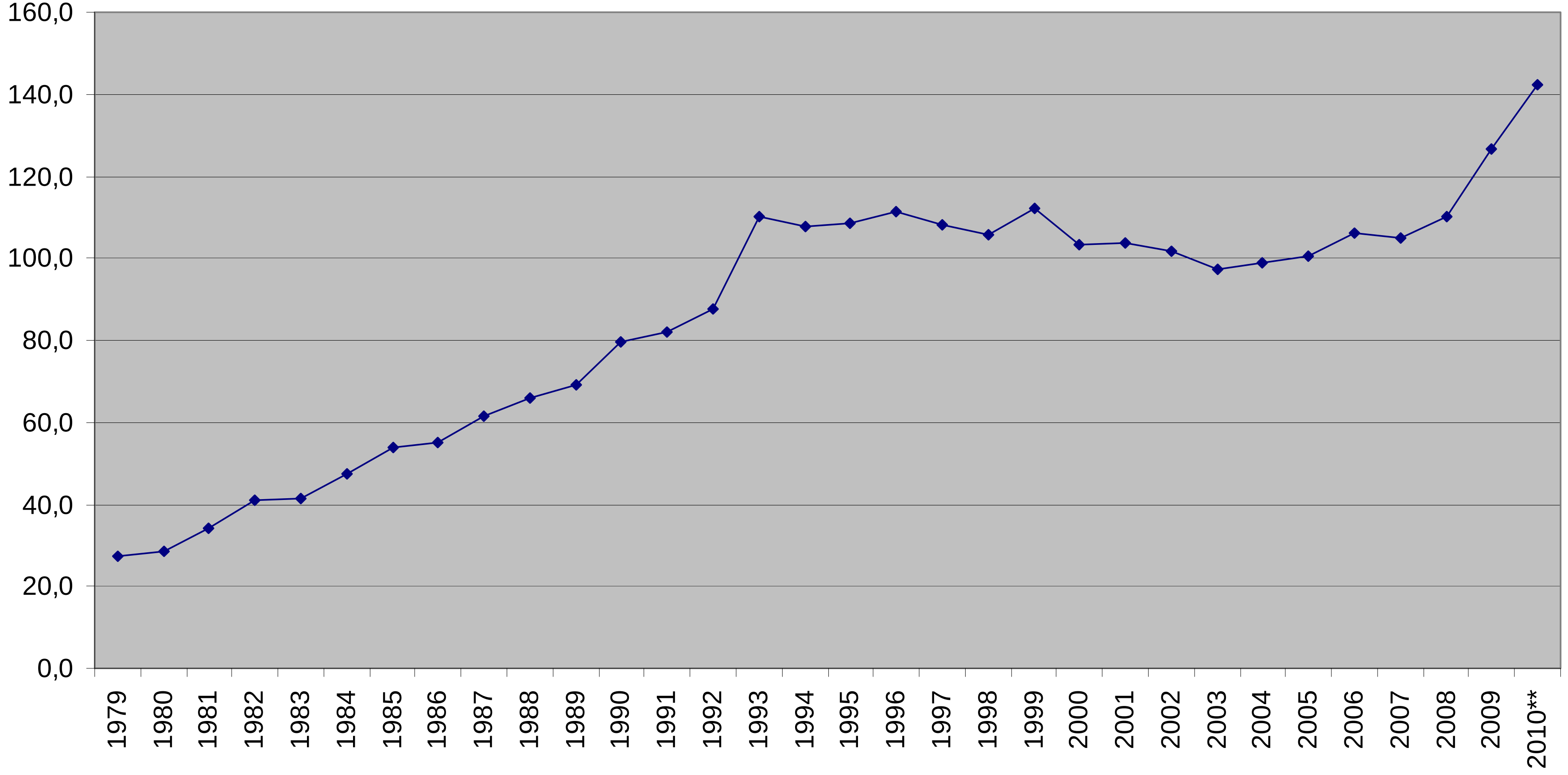


Securing EMU membership: 1994-1999

- Taking all these into account, fiscal consolidation <u>was not sustainable</u>
- Fiscal policy inside the Euro-zone should have been
  - More <u>active</u>, to correct macroeconomic imbalances and asymmetric socks
  - More <u>flexible</u> and <u>autonomous</u>
  - More <u>disciplined</u>
  - Tax competition, migration of tax bases
- Greece entered EMU with two fundamental weaknesses
  - The debt-to-GDP ratio was too high, exceeding 100% of GDP. Adversely affects growth prospects and sets severe limitations on fiscal policy
  - The institutional fiscal framework which determines fiscal outcomes was extremely weak (not-existing)
    - Budget preparation
    - Numerical fiscal rules
    - Independent assessment

Diagram 5

General Government gross consolidated debt (Maastricht definition) (% of GDP)



Inside the euro-zone

- The traps could have been avoided by:
  - Increased fiscal discipline
  - Increasing the competitiveness of the economy

- Greece did neither of them

- Macroeconomic developments in the 2000-2004 sub-period
  - Strong economic activity (4.5% real growth)
  - Very low inflation (3.3% annually) but higher by 1.5 pp than the EZ
  - High consumption, fuelled by rapid credit expansion
  - High investment growth (6.9% average)

- Inevitable easing of monetary conditions
  - Sharp decline in interest rates (end 1999-end 2006)
  - Elimination of credit restrictions
  - Reduction of reserve requirements from 12% to 2%

Inside the euro-zone : 2000-2004

- Fiscal developments
  - Fiscal policy should have offset the loosening of monetary policy
  - On the contrary, fiscal policy loosened progressively
  - Significant tax cuts from the first year
  - Primary surplus declined and as of 2003 turned into deficit
  - Repeated revenue short falls and expenditure overruns

- Public debt remained broadly stable
  - Despite extremely favourable conditions the debt-to-GDP ratio remained broadly stable (high GDP growth, historically low interest rates, primary surpluses [up to 2003], revenue from privatizations)

- Significant fiscal deterioration in 2003 and especially in 2004, despite the fact that in 2004 Greece was under the EDP

Inside the euro-zone : 2000-2004

- Greece was subjected to the Excessive Deficit Procedure (EDP) in mid 2004
  - Immediately after the March elections, Greek authorities notified Eurostat that 2003 deficit was 2.95% of GDP.
  - Eurostat came to Athens on 26-27 April. The 2003 deficit was revised to 3.2%
  - In May the Commission initiated the EDP against Greece
  - On 5th July 2004 the ECOFIN Council decided that Greece was in excessive deficit

- Greece was asked:
  - To put an end to the excessive deficit by end 2005 at the latest
  - To take effective action and submit a package of measures by November 5th

Inside the euro-zone : 2000-2004

- Insufficient measures
  - Commission: Greece did not take effective action
  - Over and above fiscal revisions and slippages related to the Olympic Games “…the fiscal policy stance further worsened in a situation of buoyant economic activity…”
  - Thus Greece was moved to Art. 104, par.9
  - Greece took additional tax measures on 29 March 2005 (Updated Stability and Growth Programme)
- As a result of the “fiscal audit”, deficit and debt figures for 2000-2004 were repeatedly and significantly revised
- The fiscal revisions created uncertainty about the true state of Greek public finances. finances

Inside the euro-zone : 2005-2009

- Fiscal developments
  - Given that Greece was in the EDP, fiscal policy was given. Reduce deficit below 3.0% by end 2006

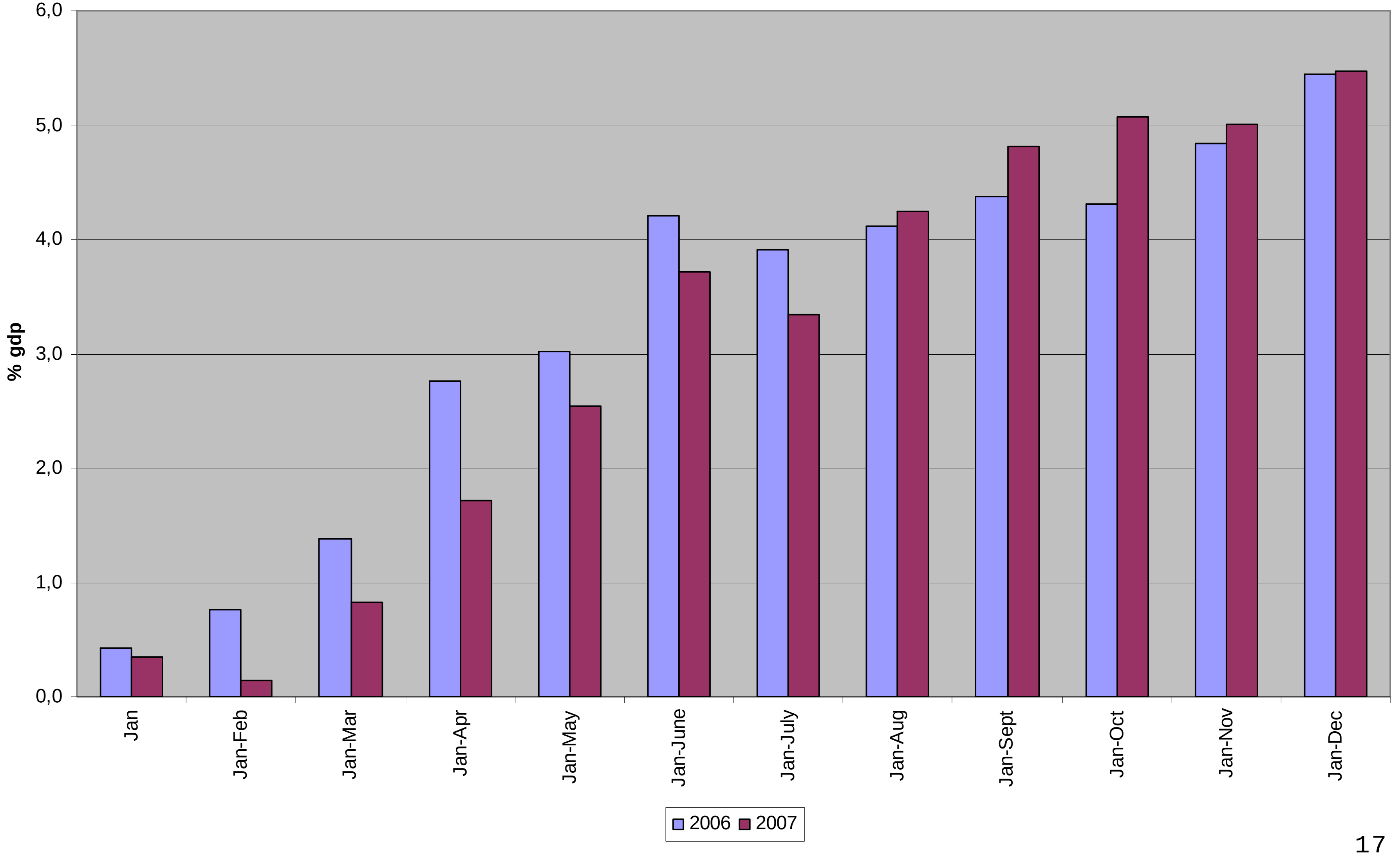
- Deficit declined to 2.6% of GDP in 2006 (later revised several times to 5.3% of GDP)

- As with the 1994-1999 consolidation, *the new consolidation was not a sustainable one*
  - Expenditure were not cut on a permanent basis
  - In a year's time deficit exceeded again the 3.0% reference value
  - Good fiscal performance in the first semester of 2007

- On the basis of 2006 outcome, the EDP ended on June 6th 2007

- Fiscal magnitudes deteriorated in July-August 2007

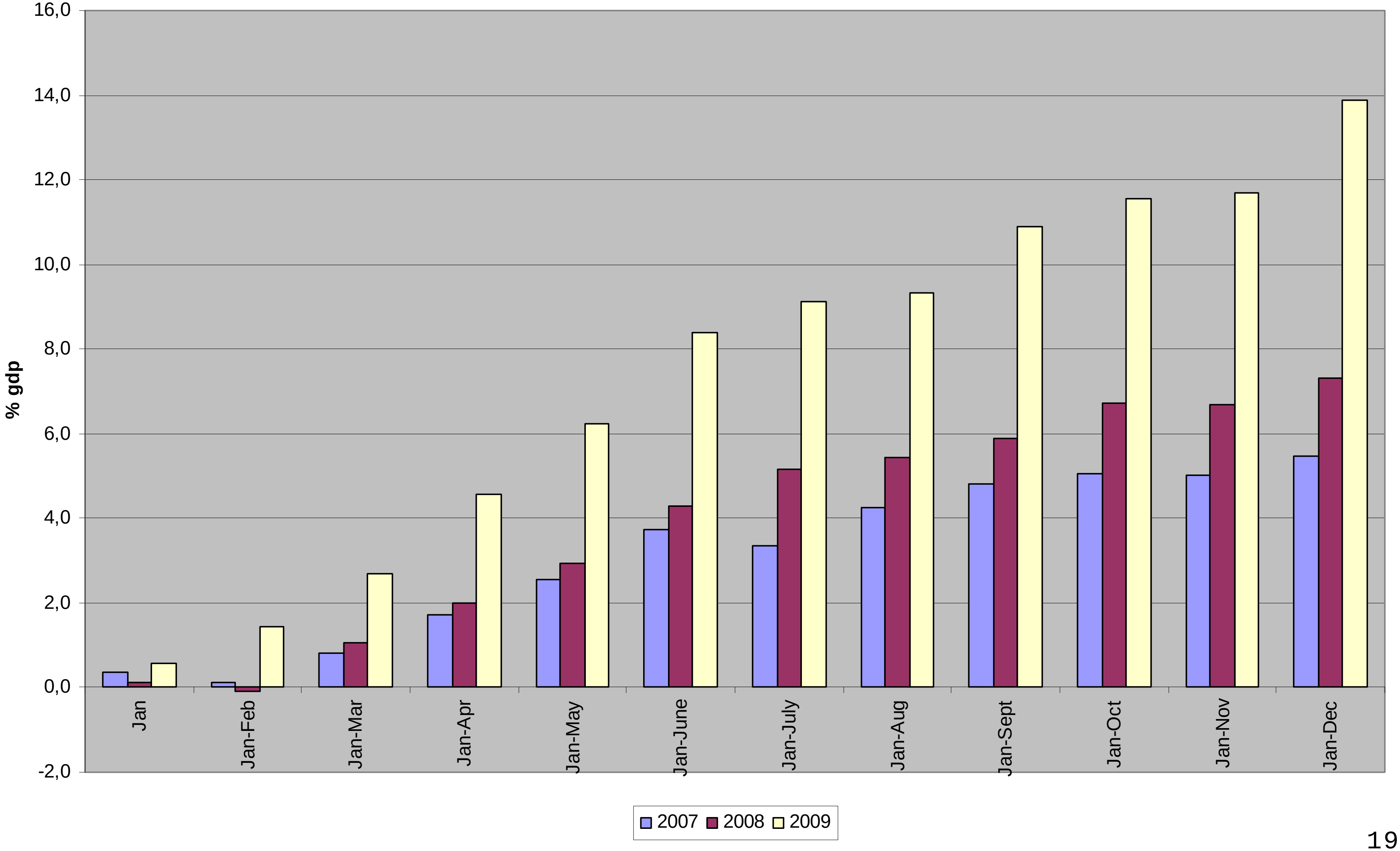
Diagram 6
Central government cash deficit 2006-2007
(% GDP)



Inside the euro-zone : 2008

- 2008 was a pivotal year
  - GDP growth decelerated but remained positive
  - Large deterioration in fiscal outcome
- Revenue shortfall by 1.3% of GDP (3.3 bill.euro)
- Expenditure overruns by 1.2% of GDP (3.0 bill.euro)
  - Press reports: "…government gave up any effort to reign in waste…"(December 2007)
  - IMF: "…the quality of expenditure adjustment in the 2008 budget falls short of what is needed to ensure sustainable consolidation."
- In April, Bank of Greece warned about debt dynamics
- In their Spring forecasts all international organizations projected a deceleration in GDP growth in Greece
- Despite continuous worsening of monthly fiscal data and macroeconomic prospects <u>no measures were taken</u>.

Diagram 7
Central government cash deficit 2007-2009
(% GDP)



Inside the euro-zone : 2008

Rising spreads

- Spreads began to rise since early 2008
  - 5 March Triche warned Greece and Italy
  - June, July debt issues had much higher yields

- On 1st September 2008 Standard & Poor's and Fitch warned that unless Greece managed to contain public spending and reduce public debt, its credit rating would be lowered

- As the international crisis intensified spreads rose (10 year bonds) considerably

- Following the December 2008 demonstrations in Athens spreads rose again

- At this juncture Greece should have sent a strong message to the markets

2009 and the Crisis

- The 2009 budget was outdated before the beginning of the new year
  - By 30 January, the 2009 budget had been completely revised
  - The 2009 deficit was estimated at 3.7% of GDP
- The execution of the 2009 budget went seriously off track
  - Every single month deficit was much higher than in previous year
  - Monthly data were not published (only in April and July)
- Revenue shortfall: 12,744 mill. euro or 5.4% of GDP
- Expenditure overruns: 6,176 mill. euro or 2.6% of GDP
- Deficit 30,102 mill. euro or 12.5% of GDP

2009 and the Crisis

- On 27th April Greece was subjected again to the EDP, on the basis of 2007 and 2008 deficits
  - The Commission clearly stated that these deficits were <u>structural</u> and <u>were not due to the international crisis</u>
- Greece was asked to correct the excessive deficit situation by the end of 2010. <u>In 20 months</u>
- Greece was given <u>7 months</u> time to submit measures to the Commission (27 October 2009)
  - Commission is responsible for this
- Insufficient tax measures taken reluctantly in late June 2009
- <u>The package of measures for EDP was never prepared</u>

The crisis

- The last opportunity to send a strong message to the markets was in the aftermath of the October election

- On 22 October the new deficit estimates were published by Eurostat (12.5% of GDP)

- The same day Fitch downgraded Greece

- The 3.6% of GDP deficit reduction provided by the 2010 budget did not satisfy markets

- Sovereign bonds downgraded again on 8,16 and 22 December by Fitch, S&P and Moody's respectively

The crisis

- In the Updated SGP the decline in deficit was envisaged to 4.0 % of GDP
  - On 26th January 2010 spreads were at 369 pb
- Significant fiscal measures taken on 9th February and 4th March did not appease the markets
- A new round of downgrading in April 2010
- April 11 Eurogroup decided to help Greece

Conclusions : Long term problems

The current sovereign debt crisis has deep roots:

1. Continuous deficits for the last 36 years

2. High and rising public debt

3. No systematic efforts to control expenditure or contain tax evasion

4. The three fiscal consolidations (1986-1987, 1994-1999 and 2005-2006) were not sustainable

5. Continuous worsening of competitiveness after EMU entry

6. Greece entered EMU without adequate preparation and fell into both traps: the debt trap and the competitiveness trap

7. The magnitude and the frequency of the fiscal data revisions dealt a serious blow to the country’s credibility

2008-2009 developments and the crisis

1. Plenty of warnings since the beginning of 2008. Plenty of time to take measures

2. Huge expenditure overruns and revenue short falls. Unwillingness to take coherent significant fiscal measures to correct the situation

3. Huge current account deficits

4. When the international crisis hit the Greek economy (fall 2008), fiscal developments and outlook were bleak

5. Second EDP in April 2009, on the basis of 2007-2008 deficits. Structural not cyclical. Not related to the international crisis.

6. Commission granted a very long time for Greece to take action and submit measures

7. No action was taken according to EDP conclusions

2008-2009 developments and the crisis

8. To deal with a debt crisis, decisive and immediate bold action is required. Later it would be much more difficult. A strong message to the markets is required

9. The October elections was the last opportunity for Greece to signal a turnabout of fiscal stance. Markets' power was underestimated

10. 20% of total debt was created in 2008-2009

11. The international financial crisis did not cause the sovereign debt crisis in Greece. It <u>revealed</u> and <u>aggravated</u> existing macroeconomic imbalances and structural fiscal problems

12. The debt crisis adversely affected the liquidity of the banking sector in Greece, because Greek banks were cut off the interbank market

Thank you