HIGHLIGHTS

Highlight 1. The Greek Crisis – Causes, Myths and Lessons

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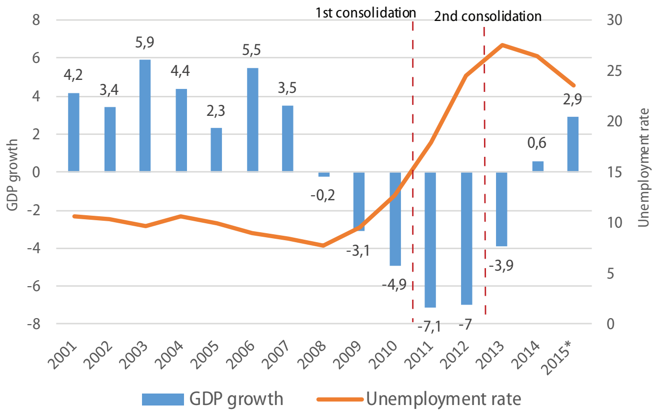
Modern Greek state, since the liberation from Turkey (in the first half of the 19th century) until today has *de facto* bankrupted five times. The first bankruptcy occurred right after the liberation from Turkey, because the state could not pay its debt to the British banks, which was taken out in order to purchase weapons for the uprising. The last public debt crisis, which has lasted since 2010, is also in a wider sense a bankruptcy, because the state was not able to service the entire debt under the existing conditions, which is why part of the debt was written off, payment period extended, and interest rates reduced. Frequent public debt crisis in Greece indicate society's high tolerance to borrowing and a low degree of institutional development, which is necessary for ensuring sustainability of public finances.

Causes of Crisis

Since entering Eurozone (in 2001) until the crisis (in 2008), Greek economy was growing at a rate of 4.2% (Graph 1), which is significantly faster that the Eurozone average, primarily due to strong increase of state and personal consumption. As a result, since the beginning of the crisis Greece has had an extremely high current account balance of payments deficit which in 2008 reached almost 15% of GDP, which caused considerable dependency on inflow of foreign capital. High level of foreign deficit in the long term indicates Greek economy's uncompetitiveness, which was mostly caused by the policy of high wages (in relation to productivity) and inability to use currency depreciation as a mechanism of improving international competitiveness. Global financial crisis has caused a significant decline in capital inflow, which in 2009 caused a problem with financing foreign debit and its consequential decline by one third. Decline of foreign capital inflow automatically caused a strong decline of GDP, citizen consumption, and tax revenue, i.e. an increase of fiscal deficit and public debt already in 2009, before Greece applied austerity measures.

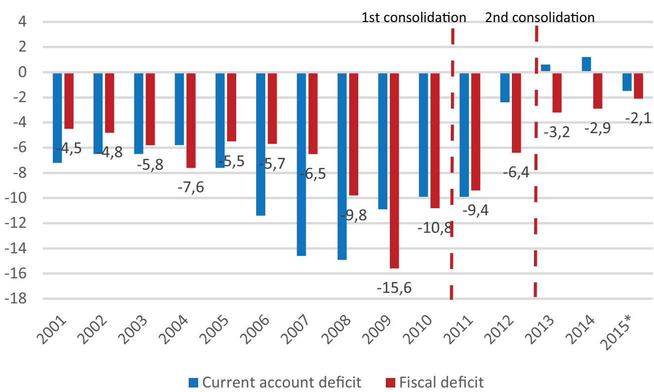
Graph 1. Greece: GDP Growth Rate and Unemployment Rate



Source: Eurostat

Aside from external imbalance, Greece has had a significant internal imbalance as well during the past decades, primarily in the sense of high fiscal deficit. Even in 2001, which was the first year of its membership in Eurozone, Greece's fiscal deficit (4.2% of GDP) was higher that the limit prescribed by the Maastricht Treaty, only to continue growing in the following years. In the period 2001-2008 the fiscal deficit was on average 6.3% of GDP, and from 2009 to 2014 it was around 8% of GDP. Significant contributing factors were the failed implementation of the 2001 pension reform, tax reduction (reducing VAT rate before entering Eurozone in order to meet the inflation requirement), continued policy of uncontrolled public sector hiring, and very broadly defined rights in the public sector (wages, supplements, social contributions, etc.), which made the share of current spending in the overall public spending in Greece significantly above the European average. Also contributing to the high fiscal deficit was the high level of corruption

Graph 2. Greece: Consolidated Fiscal Deficit and Current Account Balance of Payments Deficit (% of GDP)



Source: Eurostat

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and tolerance toward grey economy. In addition, high foreign deficit and the resulting high revenue from consumption tax stimulated the continuation of expansive fiscal policy, blurring the true picture of a high deficit.

High current account balance of payments deficit (14.9% of GDP) and high fiscal deficit (9.8% of GDP) in 2008, made Greece very exposed to the shocks caused by global economic crisis – decline in foreign capital inflow made the country's external position unsustainable, and high fiscal deficit and small fiscal multipliers narrowed the country's manoeuvring space to use countercyclical measures of economic policy in order to absorb part of the negative external shocks on economic activity. That is why in 2009 Greece entered into recession. Unlike other European states that managed to stabilise in 2010, recession in Greece was additionally deepened in that year as a result of a strong decline in trust in the sustainability of public finances, due to an extremely high fiscal deficit and very high public debt. Discovery that the real fiscal deficit in the past years was much higher than the officially announced one (thus, the estimated deficit for 2009 was revised from 7% of GDP to 15.6% of GDP) additionally increased investors' distrust in the sustainability of public finances. Thus, access of Greece to international financial market was limited, so the aid of the European Union and IMF was necessary in order to provide liquidity of the state (for servicing matured obligations and financial deficit). The aid arrived as part of the First Programme of Economic Reforms (concluded with EU, ECB and IMF), which included implementation of a strong fiscal consolidation until the end of 2010 and a series of structural reforms. A similar scenario was applied to the Second Programme as well, which included implementation of additional measures of fiscal consolidation until the end of 2012 and further structural reforms (privatisation, public sector reform, etc.). Since Greek fiscal deficit was extremely high and mostly of structural nature, i.e. result of discretionary decisions on reducing taxes and increasing spending, implementation of a strong fiscal consolidation was necessary and justified.

Macroeconomic data for 2014 and preliminary assessments for 2015 (made before the radical left came to power) indicate that implemented measures of fiscal consolidation and other structural reforms started to yield results – fiscal deficit was reduced to 2.9% of GDP, current account balance of payments deficit was eliminated, so in 2014 a surplus of 1.2% of GDP was realised, and after declining for six previous years, GDP in 2014 recorded a real growth of 0.6%, while unemployment rate dropped from 27.5% (in 2013) to 23.5% (in 2015). Stopping reforms and fiscal consolidation in mid-2014, as well as the radical turn with the election of the new Government at the beginning of 2015, caused the trust of investors and consumers to strongly decline, which slowed down or reversed the positive trends from 2014. Slower than planned growth of economic activity and consequently a higher fiscal deficit have led to the need for the Third Programme of reforms, concluded in August 2015, to include even stricter measures of fiscal consolidation than was initially planned in order to achieve originally envisioned fiscal goals. So giving up on reforms in their final stage, when the toughest measures of consolidation had already been implemented and started to yield results, will have a negative impact on economic recovery and macroeconomic stabilisation, because after new fluctuations it will be considerably harder to regain the investors' trust.

Myths

We can often hear in the public here and abroad some unfounded claims regarding the economic crisis in Greece and implemented programmes of fiscal consolidation which often do not correspond to the facts and are only confusing the broader public primarily regarding the need for implementation of fiscal consolidation and its effects.

For example, we often hear a claim that the decline of economic activity in Greece, which between 2008 and 2013 cumulatively amounted to 26.2%, is the result of austerity measures. Data on the growth rate of GDP (Graph 1) show that the strong decline of economic activity in Greece started back in 2008, long before the implementation of fiscal consolidation, which started at the end of 2010. Thus, the decline of GDP before 2011 cannot be ascribed to fiscal consolidation, i.e. to austerity measures, while the decline of GDP after that can for the most part, although not entirely, be ascribed to austerity measures. It can therefore be concluded that the recession in Greece is primarily the result of a low level of the economy's competitiveness and the resulting structural imbalances (high foreign deficit), as well as lack of investors' trust in macroeconomic stability of the country (which reflects on the drop in investments). So, unit labour costs in Greece in the period 2001-2010 increased significantly (by around 12%) while they mildly decreased in the rest of the Eurozone (by around 3%), which undermined the country's competitiveness. This is the consequence of a growth strategy based on domestic demand, financed by borrowing and growth of wages above the growth of productivity, as well as the inability to improve international competitiveness by currency depreciation (due to the membership in the monetary union). Implemented fiscal consolidation also contributed to the decline of GDP, but its influence is smaller than that of factors related to competitiveness and macroeconomic instability, because in a small open economy, with relatively undeveloped industry and significant dependency on export of services (tourism), fiscal multipliers, as a rule, are not very high. On the other hand, it is possible that a different structure and dynamic of fiscal consolidation could have had lesser negative effects on economic growth. In support of this argument is the fact that total reduction of expenditures and increase of revenue due to applied measures of fiscal consolidation is considerably higher than the realised reduction of deficit, and that the difference can be ascribed to the change in economic structure, as well as negative effects of fiscal adjustment to economic activity.

Second claim often heard in public indicates that fiscal consolidation does not contribute to the reduction of fiscal deficit, as the resulting decline of GDP and tax revenue is higher than direct effects of consolidation. Data on the trends of fiscal deficit indicate quite the opposite – that through the implementation of fiscal consolidation measures, the fiscal deficit of Greece in the period 2009-2014 was reduced by 13.5% of GDP, from 15.6% to around 2.1% of GDP. This proves the rule that reduction of fiscal deficit which occurred due to discretionary measures (reduction of taxes/increase of spending) requires an implementation of opposite discretionary measures (increase of taxes/reduction of spending).

Third claim refers to high (usurious) interests imposed on Greece for the public debt significantly contributing to its fiscal deficit. Level of interest rate at which a country borrows funds on the market depends on the sustainability of its public finances, economic growth perspective and conditions of borrowing on the global financial market. Due to the policy of extremely high deficit and resulting growth of public debt, which has continuously been at the level of over 100% of GDP since 1999, interest rates on Greece's loans grew as well. However, the First Programme in 2010 significantly restructured the public debt – debt toward private creditors (primarily banks and investment funds) was mostly paid off through loans to Greece from the EU member states, and the interest rates on loans from EU member states were quite low and the payment period was extended (average maturity of Greek public debt is around 17 years). This way, the EU member states gave a considerable contribution to the fiscal consolidation in Greece through a significant reduction of interest cost in 2011 and the following years. Thus, the effective interest rate of the remaining debt of Greece (interest expenses/public debt) dropped from 4.9% in 2011 to 2.5% in 2014, which on average caused the interest expenses (and total expenses and total fiscal deficit) to be lower by around 4% of GDP annually. Effective interest rate on the country's long-term borrowing of 2.5% is considered quite favourable, even for the countries with a much lower debt level and better macroeconomic performance than Greece. As a comparison, in 2014 Greece had a debt of 170% of GDP and was paying interest of 4.5% of GDP, while Serbia with a debt of around 70% of GDP paid interest of around 3% of GDP (effective interest rate for Serbia is 4.2%). Stated data show that through two programmes Greece received an effective write-off of a significant portion of future obligations (through reduced interest rates and extended period of payment), and that the remaining part of fiscal adjustment should be implemented through other measures. On the other hand, it is often stated that by approving aid to Greece through two programmes, EU countries were practically saving their banks from large losses from potential writing off of Greece's debt. This claim is mostly true, where the argument for implementing such a policy is the need to ensure stability of the banking system, while the unequivocal downside of this decision is the transfer of cost of risky management behaviour of these banks from their shareholders to all tax payers.

Forth claim that is especially widespread in the public is that, unlike some other countries (e.g. Germany in 1953), Greece never had its debt written off. However, the facts are quite different, because in 2012 Greece did have 105 billion euros of its public debt written off by private creditors (mostly banks) which at the time was around 28% of its public debt. In addition, taking over of the biggest part of Greek public debt by non-commercial creditors (EU member states and international organisations), the interest rates on Greek debt were dramatically reduced compared to the market interest rates at which Greece borrowed money, but also compared to the interest rates at which other countries borrow money as well (e.g. Serbia, Croatia, Hungary). Depending on which interest rate is taken as a reference point, it is estimated that the reduction of interest rates indirectly wrote off between 1/3 and ½ of the Greek debt. The misconception that Greece never had its debt written off probably comes from the fact that soon after it was written off, the Greek debt reached an amount very close to the one before it was written off?! There are three main reasons why Greek debt reached its old level soon after it was written off. First, Greece did a recapitalisation of its banks in order to prevent their bankruptcy[3]; second, due to late fiscal consolidation, the fiscal deficit was even after the debt was written off still quite high, so its fi-

3 There is a bit of an absurd claim in the public that Greece saved its banks in order to protect the interests of world powers. Saving of Greek banks is primarily in the interest of the citizens of Greece, because their mass bankruptcy would additionally worsen the crisis in the country. A hypothetical mass bankruptcy of Greek banks would have a negative impact on the countries of South-East Europe where Greek banks are present, while the negative effect on developed countries would be relatively modest.

nancing led to another strong growth of public debt. Sharp decline of GDP in 2012 and 2013 also affected the growth of debt to GDP ratio.

Another widespread misconception is that the banks, especially foreign ones, made a huge profit on loans they approved for Greece. However, the truth is that by writing off a large part of the debt, the banks incurred big losses in 2012 from the Greek public debt. Just what effect business with Greece had on the banks is best described on the example of Cyprus whose banking system was on a verge of bankruptcy after the Greek debt was written off. Big western banks also incurred losses in doing business with Greece, but thanks to their size they were able to withstand those losses. As in previous cases, there is a reason why a superficial observer was misled. During the period when the agreement with the creditors was uncertain, Greece borrowed several billion euros at very high interest rates in order to bridge liquidity. However, the share of those expensive loans in the total loans was pretty insignificant, so they didn't affect the trend of average effective interest rates.

The next misconception concerning the Greek public debt is that it is often claimed that Greece has no prospects for recovering its economy due to the huge cost of servicing the loan. However, the cost of servicing Greece's public debt (as % of GDP) in the next ten years will be lower than the cost of servicing the public debt of many European countries, including Serbia. The reason is that Greek interest rates are quite low and the average maturity is 17 years, which is twice as long as in other countries. Therefore, servicing public debt will not pose a bigger burden on Greece in relation to GDP than in any other European country. However, in this case there are facts that are seemingly supporting this misconception and that is that the Greek public debt under current conditions of financing will stay quite high in the future. If Greece tried to lower the level of its debt from high fiscal surplus, it would probably lead to economic exhaustion of the country. That is why it is pretty certain that Greece's recovery requires part of the public debt to be written off, after Greece stabilises the deficit at a very low level or transfers to the surplus. And Greece's problem are not high costs of servicing the debt in the coming years, but the inability to reduce the absolute level of the debt and its relation to GDP.

Finally, another wrong claim that is stated in European public is based on the stand that Greece is not implementing reforms, but is waiting for the burden of its spending to be permanently financed by tax payers of other European countries. According to the official data, in the period 2009-2014, Greek fiscal deficit was reduced by 13.5% of GDP, while structural fiscal deficit was reduced by as much as 16.7% of GDP (so in 2014 a structural surplus was realised of 2% of GDP). That was a very large fiscal adjustment in a relatively short period of time, which was necessary having in mind the high deficit and the dynamic of the public debt. The First Programme of fiscal consolidation (2010-2011) was evenly distributed between the reduction of spending and increase of taxes, while the Second Programme (2013-2014) was mostly based on the reduction of spending. As a result of recession and fiscal consolidation, average disposable income of households in the last five years has dropped by around 35%, which indicates that great efforts were made in Greece to regain the sustainability of public finances. Besides, significant part of work was done in the domain of structural reforms, also proven by Greece's high ranking on the OECD country list, ranked according to the speed of implementing recommendations for accelerating economic growth.

Lessons

Greek public debt crisis offers an opportunity to draw many lessons, most of which are relevant to Serbia.

It is important that the growth of economy is sustainable in the long term, and growth is sustainable if it is realised with little internal and external imbalances. In the period 2001-2007, Greece was realising high growth rates of GDP and even faster growth of income and consumer spending, but at the same time, it had high deficit in the current balance of payments and high fiscal deficit. Such a growth model means that a large part of investments and spending is financed by foreign loans and foreign direct investments. Problems are even bigger if the foreign loans are used to finance current spending, and bigger part of foreign investments goes to the sector of non-tradable goods.

It is important that the democratic processes used to pass decisions on fiscal and other economic policies are considering the long-term consequences of adopted policies. There is a risk in young democracies of establishing unsustainable arrangement between politicians, who are using the loans to finance high consumer spending, and citizens who are tolerating their corruptive actions and give them support in elections. Politicians, bureaucrats and citizens should resist the temptation to temporarily increase spending at the expense of the citizens of other countries and the expense of future generations of their own country. Increase in spending through taking out foreign loans that cannot be or will not be repaid has limited range, while spending at the expense of future generations is morally questionable.

High deficit in current balance of payments poses a risk not only to the country's growth but to the sustainability of its public finances as well. High deficit can be financed as long as there is a trust of foreign investors, but when it is gone for whatever reason, then that leads to forced reduction of the foreign deficit, but also to the decline of private spending, investments and, consequently, the GDP as well. Decline in GDP automatically leads to a decline in tax revenue, which increases the fiscal deficit and public debt. This is exactly what happened in Greece in 2009-2010, when sudden reduction in the inflow of foreign capital led to the decline of GDP, before the Government applied austerity measures.

It is important that the national currency exchange rate be adjusted to other macroeconomic variables, such as productivity and earnings. If the exchange rate is not aligned to productivity and earnings, then it is possible that the country is realising high growth with foreign deficit, financing of which depends on the moodiness of the global capital market. Countries that have a fixed exchange rate, such as Greece, maintain the macroeconomic balance through adjusting salaries, pensions, etc. with the exchange rate. In case of a country with a flexible exchange rate, such as Serbia, the alignment can be implemented through income policy and control of domestic demand, as well as through the exchange rate policy.

If a country has a high fiscal deficit, it is necessary to start consolidating as soon as possible, and measures of consolidation should be strong enough to reduce the deficit in a short time to a sustainable level. Timely implementation of strong consolidation measures is especially important in the case of small economies which have a low credit rating and have no potential for applying fiscal stimuli which would initiate economic growth through increased state spending. A large number of countries at the beginning of the previous crisis applied such measures of reducing fiscal deficit and they resulted in a deep but short-term decline of GDP, followed by a strong recovery of their economies. The experience of Baltic countries, Romania and even Serbia this year is definitely refuting the claims of some economists that austerity measures only worsen the crisis. Delaying fiscal consolidation and hesitating during its implementation only increase the cost of consolidation. Recovery of Greek economy began in the second year after the decisive measures of fiscal consolidation were applied in 2012.

Experience of Greece, and other countries as well, shows that the success of fiscal consolidation, and sustainable economic growth, requires persistence in its implementation. Even a short detour from fiscal consolidation after initial good results, as Greece has done this year, will only increase the cost of fiscal consolidation and delay the economic recovery. In that sense, the experience of Greece, which (temporarily) gave up on fiscal consolidation and structural reforms in their last stages and then came back to the reform programme but under worse conditions, can be educational for other small open economies which are implementing such reforms (e.g. Serbia) in the sense that the success of reforms requires perseverance in their consistent implementation, so that the initial success in their implementation would not be lost due to losses related to the interruption of reforms. Besides, the recent experience of Greece shows that small and medium countries (in economic sense) cannot affect change in the principles of global economy, because that would only be possible within a wider simultaneous action of a larger number of big and economically strong countries, which is highly unlikely. Instead, small and medium countries at the middle level of development should direct their efforts toward optimising their policies in the given context.

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