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Economists' Blurry Greek Crystal Ball

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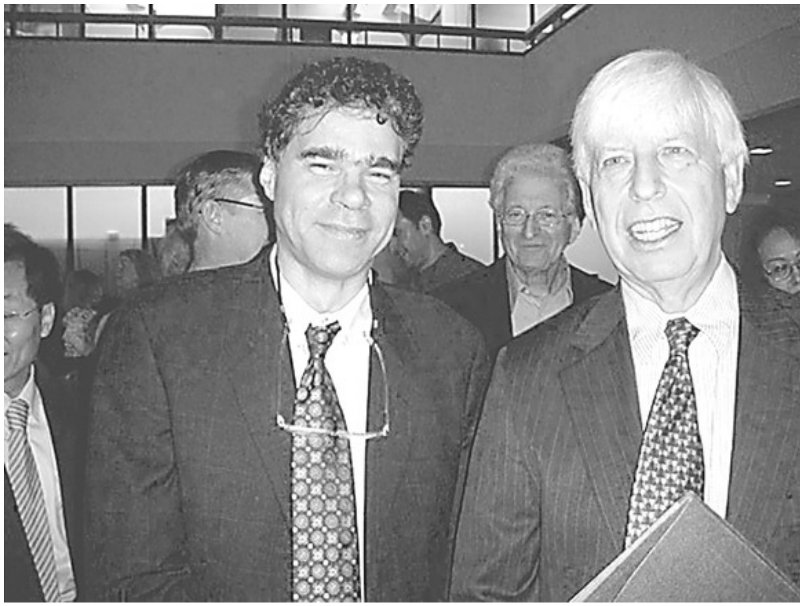
NEW YORK – It's been said if you get a group of economists in the same room you won't get the same answer to a question. But when a group of some of the best met here to discuss why the Greek economy turned sour and what happens next, they had a consensus: the country will have to inevitably default. The March 28th program, The World Financial Crisis – The Case of Greece was aimed at sorting out what happened in Greece and why, and the analysts said it was a worst case scenario in which almost everything went wrong, from an unproductive – one called it "useless" – public sector, to uncontrolled tax evasion and, perhaps its biggest bugaboo: mistrust. The guests were welcomed by Greece's Ambassador Aghi Balta, who thanked the Stavros Niarchos Foundation for its support, as did the moderator, Prof. George Syrimis, Associate Program Chair at the Hellenic Studies Program, who introduced the panel beginning with John Geanakoplos, James Tobin Professor of Economics at Yale and co-founder of the Hellenic Studies program in 2001. For many economists, math is the reality, and Geanakoplos began with a focus on the numbers that have the greatest impact on the actions of markets and governments, providing a clear picture of the Greek situation: bleak in terms of avoiding default, bright with respect to its consequences, which he explained would be good both for Greece and its debtors. He noted that Greece owes about 300 billion Euros ($420 billion,) which amounts to 141% of its Gross Domestic Product (GDP.) Geanakoplos noted that even countries with a 50% threshhold have defaulted on their debt and that Greece's level means each year it must pay $42 billion interest, and refinancing means Greece must borrow $98-$112 billion per year. To help Greece survive, the European Union and International Monetary Fund (IMF) is providing $150 billion in loans over three years, but on the condition harsh austerity measures were imposed. Geanakoplos showed how a series of Greek governments did nothing to correct the problem of heavy borrowing as the state's tax revenues declined, but he gave credit to Prime Minister George Papandreou for reducing the government's primary budget deficit (excluding interest payments) in one year from 10 to 3.3%. Despite that, he said, Greece's debt hasn't declined. The bleak numbers led the panel to conclude that a Greek default, controlled or otherwise, is inevitable.

Geanakoplos then described a fortunate peculiarity in Greece's situation: 90% of Greek bonds are issued under Greek law, and under the complete control of Greece's government, which means lenders could lose all their investments. But, rather than burning bondholders – which would wreck Greece's ability to borrow - other speakers suggested it could offer them a "haircut" of a 30% reduction in the bonds' value. Historically, if troubled countries can get half its investors to agree to a restructuring of payments the rest have generally gone along. Greece's bailout means that within five years, 50% of its debt will effectively have been shifted to the IMF and EU, who could recommend private banks accept reduced returns.

Geanakoplos turned to Shakespeare, who he said had a good grasp of the emotional and economic dynamics of borrower/lender relations. In the Merchant of Venice, the careful spectator concentrates on the collateral's ratio to a loan instead of the rate of interest. He also cited Portia's "Quality of Mercy" speech, that forgiveness benefits the transgressor and the victim. That includes debt forgiveness, which Geanakoplos said is the way to go regarding Greece.

Costas Meghir, the Douglas A. Warner III Professor of Economics at Yale, said Greece was a crisis waiting to happen. That it was revealed but not caused by the international financial crisis is understood by looking at decades of mismanagement and the failure to undertake structural reforms, he said. The historical trend is clear: "In 1980 the debt-to-GDP ratio of Greece was a healthy 25 percent, but it kept inexorably rising. He asked: "Where was this money going?" and said that during the past 30 years, Greece’s ratio of consumption to what it produced (GDP) rose, while investment to GDP, a measure of what the country was doing to increase its productive capacity – declined. Its governments moved away from spending on infrastructure to an increasing public sector payroll. By 2000 the resulting problem were becoming very apparent, but entry into the Eurozone of countries using the euro allowed them to be swept under the carpet.



John Geanakoplos , James Tobin Professor of Economics at Yale, seen with Karl Shell of Cornell, brought Shakespeare into the discussion of the Greek crisis.

Meghir presented graphs that showed Greece compared unfavorably with the members of the EU and other developed countries. Its tax system is notoriously inefficient. In Greece only 8% of GDP is collected through taxes while the EU average is 13.4%. Greece could have covered its debt simply by curtailing the national sport of tax evasion, which costs about $40 billion a year. Meghir exploded the myth that Greece’s public sector is very large by showing that its wage bill is not far from the EU average of 11% of GDP, but he stated bluntly that the problem is that "The Greek public sector is completely useless" and unproductive. He noted that workers can’t be transferred and if an office has a shortage it’s filled with temporary hires who become permanent through politics. More disturbing, he said, is that while Greeks rate education a priority, it’s one of the lowest-rated in the EU, despite having one of the highest teacher-to-student ratios. Studies also show Greece is the most corrupt EU country, ranked with countries such as Italy, Bulgaria, Romania and Turkey. "This is not good for business," he commented. He also said Greece’s judiciary system is a wreck.

"In Greece it takes an average of 819 business days to solve a commercial dispute. In the worst cases, a decade can go by. Practically this means you do not have a formal way of enforcing contracts," which is not good for foreign investment, and is one elements in Greece’s notorious lack in investor protection.

The labor market is also a disaster for the economy, with the highest youth unemployment rate in the EU, 22%. He said the problem is rigidity. Businesses are reluctant to hire because it's so hard to fire people who don't work out. Another ironic statistic shows the Greeks work the most hours in the EU, "But they are extremely unproductive," he said. Heads shook in disbelief when he declared that the productivity of Greek workers is about 7% of the EU average.

He said that uncompetitiveness could be reversed if Greece harnesses its untapped talent through reforms. Ambassador Balta said, "I don't believe in numbers. They can mislead sometimes. This discussion could have taken place last year and we could have said the same things, but many things have taken place in the past year." She noted the reforms that have taken place in the education, health and other areas in the public sector, some of which have been very cutting edge, and said it would be an injustice to Greece not to mention its assets. "No one is contesting the numbers and the huge debt, but we have decided to do something about it, and we are doing it. And we are not alone. We belong to the Eurozone and are not the only ones facing these problems."

BAIL! BAIL!

Regarding the current program bailouts and insufficient reforms Meghir said, "It does not make sense to continue like this." He said Greece has to consider defaulting on its debt and should start negotiating with its EU partners to do it in an orderly fashion to prevent being cut off from the financial markets. He said more radical reforms are needed and that default might make that easier politically because it will permit a fairer distribution of the burden. Manolis Galenianos, Assistant Professor of Economics at Penn State, explained that the EU and IMF had to step in because financial markets have been unwilling to lend money to countries in crisis. The response of the EU was to tap a support mechanism whereby Greece can get the money from the EU and IMF to help reduce its deficit to 3% by 2015 when it will be able to return to private markets for its borrowing needs. He said that's a solution for a temporary liquidity problem, but the wrong plan for Greece because Greece has a solvency problem. Galenianos said Greece cannot possibly repay the total amount of its debt. He added that the level is actually 160% of GDP. "That means if Greece can get a rate of 6 percent (right now markets are offering an interest rate of 10 percent) Greece will have to send 10 percent of its annual output into interest payments. That is a huge number and anything that goes wrong will cause a disaster where "one of every three or four Euros the government collects in taxes will go to Greece's bondholders, a huge transfer of money from a poor European country to the richer ones." He said Greeks will not accept that. He said if the austerity measures stay on track, there will be a government surplus by 2013 – if interest payments are excluded - and at that point he said, Greece, which he declared to be "practically insolvent," will benefit, in the short term and not have to default. He said the lending markets will see this coming, and Greece will be completely cut off. "The current EU policy simply postpones default. Greece is still driving towards a cliff, but at a slower speed," he said. He agreed that restructuring would benefit borrowers and lenders and said Greece could reissue bonds worth 70% of their values, but with some guarantees, perhaps through the European Support Mechanism, or they could be collateralized by the Greek government's property holdings. He said there are problems with defaulting, including a moral hazard in which Greece could do it again if let off the hook, which he found unlikely. Galeanianos then looked at the other side of the "moral" issue: "The people who have not paid for this crisis are the people who lent the money, the bankers who did not do their job, which was to figure out how creditworthy the borrower is. So far those banks have not lost any money. All the payments have been made. It is not only economically rational it is also fair that that the banks should bear part of the costs." The remaining problem is what happens after the default when banks lose a lot of money. He said Greek banks hold about $99 billion of Greek debt. If the value is reduced by 1/3 they will lose $28.2 If the government pushes restructuring it will have to provide support for its banks. He said Greece can't ignore the holdings of foreign banks but that he didn't think their losses would create a crisis for them. He said Greece will need EU help to restructure its debt. Costas Arkolakis, Assistant Professor at Yale's Dept. of Economics, said he wasn't sure about the quality of mercy Greece could expect from Germany, and said while Meghir's list of reforms was laudable they would never happen.

Arkolakis wondered if Greece had reaped the gains of European integration, especially in trade. He reminded the non-economists of the concept of comparative advantage and that it enables countries to specialize and "do more of the things they are better at," and export goods and services successfully. Countries also capture efficiency and quality gains by obtaining the products and services of countries that do things better than they do. Arkolakis presented graphs and data that showed Greece has not taken advantage of either, but pointed out that Greece could develop its export sector and be more open to outside firms.

Nicholas Barberis, Stephen & Camille Schramm Professor of Finance at the Yale School of Management, who was called by Syrimis one of the best-known researchers in behavioral science, especially as it illuminates economic activity, shifted the discussion to the cultural dimension of the crisis. He said there has been an explosion of work on culture and economics in the past 20 years, moving beyond the dicta of the Chicago School of Economics that have dominated the field for 50 years that economic activity is best understood on the assumption that economic actors are fully rational and thus there is no room for culture in its analysis. His presentation showed how a country might place itself in the dire straights Greece finds itself in. The audience was reminded that a country's situation is the sum of countless decisions made by millions of people through the years and that those choices were influenced by their culture, including how the world is viewed. Barberis said: "It's important because if we are going to get things done together we must trust each other," and noted that in "high trust" countries there are more large organizations and firms, and government works better. Greece comes up as a low trust country, with the people demanding high regulation of product and labor markets, thinking, "If I don't trust any of you, then I want you to be regulated. You will make bad products and you'll cheat me, so I want regulation." He said research shows that trusting individuals and societies are is a powerful predictor of a wide range of behavior. He presented data from the Eurobarometer polls, a series of surveys undertaken for the European

Commission since 1973. Among the questions was how much the person surveyed trusts people from other countries; i.e., a German is asked how much he trusts Greeks. It has been found that answers are reflected in trade patterns, foreign direct investment, and purchases of bonds. An Italian person who doesn't trust the British is less likely to buy their goods, purchase their bonds, or advise his company to build a factory near London. Out of 15 EU countries, Greece is the least trusting and is the second least trusted – Italy ranks lowest. In the case of Greece, being regularly occupied and suffering civil wars has had an impact, but Barberis said he believes public education is a good place to start, with programs designed to build trust among children through group activities. By focusing on a common task students would learn the value of working together. He said he believes the Greek Diaspora with different experiences has a role to play in fostering trust among Greeks.

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