GREECE'S SOVEREIGN DEBT CRISIS AND ITS ECONOMIC AFTERMATH

ANALYSIS AND LESSONS

NIKOLAOS C. GARGANAS

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To Maria and Eugenia

Disclaimer

The views expressed in this volume are those of the author alone and should not be attributed to the Bank of Greece, with which the author had been affiliated for many years.

About the author

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He is married with a daughter and a grandson.

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Preface

The unexpected (?) storm

To start with, I must be frank with myself and the reader: I devoted my career to analysing the world economy and Greek economic developments. I have witnessed many crises. Nevertheless, I could not have foreseen a crisis of this scale and complexity in Greece. This is not because I was unaware of the unsustainable trends of the pre-crisis era. During my previous service as chief economist and deputy governor, particularly as governor of the Bank of Greece, I have always made a point, in all my public statements, of warning against the worrying growth of economic imbalances in Greece. I was especially concerned about the unsustainability of the exceptionally high and persistent inflation, the mounting current account deficits, the huge public sector deficits and the accumulating debt. Nevertheless, one could never have imagined that these perilous trends could lead to such a crisis, so comprehensive a rescue, or such a huge turmoil within the euro area. Failure to fathom the risk of such a devastating crisis was not because one was unaware that missteps and bad breaks over the 20 years to the mid-1990s and the economic policies later in the years following Greece's adoption of the euro in 2001, were wrong, unsustainable and potentially destabilising. Rather, it was because it had been beyond anyone's capacity to anticipate that the Greek economy could sink into such a deep and prolonged recession.

The reasons for writing this book

The story and evolution of the Greek sovereign debt crisis of 2009-2010 and of its aftermath have been presented in many ways, over the years, in a wide variety of experts' reports, articles and books. So why have I written yet another book about this crisis?

Simply, one reason is that, even today, five years after the long 2009-2018 experience of the crisis, despite numerous works on the crisis, most people in Greece still do not quite understand how the crisis unfolded; how and why we got into this mess, or why the crisis proved so damaging; and why the Greek authorities concurred with EU partners and the IMF to put in place such painful and controversial austerity measures, in response to the crisis. Misconceptions about what happened and why are widespread to this day, still poisoning our social and political life. Many believe that the adjustment programmes were responsible for the crisis and that these policies were wrong and therefore doomed to failure. But implementation of these programmes and the government's efforts aimed at fixing some of the key underlying problems finally were able to get the economy growing again.

The backlash was inevitable, and understandable. The crisis proved devastating, inflicting deep and lasting wounds on households and on businesses and the broader economy. However, there is reason to believe that the damage would have been far worse without the concerted rescue efforts that the Greek government and its European partners, together with the IMF, were finally able to take on. On the other hand, it is fair to argue that some of the policies put into place in response to the crisis, although ultimately successful, did not protect thousands of people from the loss of a job and from poverty. Poverty rose sharply during the crisis, especially among the young and families with children.

This book attempts to bring a fresh perspective that tries to answer these and other related questions and contribute to new insights. The intention is to analyse and explain these issues in a simple, straightforward and intelligible manner. The idea is to focus on the big picture; to provide a comprehensive analysis of the crisis and its aftermath and answer related questions of policy response rather than examine a selected number of topics. To use a citation from Bernanke, Geithner and Paulson (2019), "*To understand the roots of the crisis, it's important to know why the spark ignited, but also to know what*

Introduction

In the aftermath of the global economic and financial crisis of 2008-2009, Greece faced a sovereign debt crisis. The financial and economic crisis which affected much of the Western world started in the summer of 2007, in the United States. It reached its peak after the failure of Lehman Brothers, the now-infamous Wall Street investment bank, in September 2008. That, in turn, triggered financial panic in global markets because of a severe contraction of liquidity, which led to a recession in advanced countries during 2009. At that stage, however, this was still seen as something largely external to Greece. The country was not caught up directly in the transatlantic financial crisis. Rather, the global crisis was an indirect contributor to the build-up of systemic risk in Greece. The country suffered less than other European countries from the severe consequences of this transatlantic financial turmoil, because its banks had mainly operated locally and were not exposed to toxic assets, which lay at the root of the international storm. A large deposit support at home and conventional business models had also been of major help to the financially backed Greek banks. As later explained in detail, the seeds of the debt crisis of 2009-2010 and the severe and prolonged recession that followed closely on its steps had been sown over decades. The crisis took hold in the country because of the precariousness of its domestic economic position when the global financial and economic crisis struck. The first impact of the crisis was mainly indirect, spurred on by the country's initial and long-standing accumulated problems. Notably, these included the accumulation of macroeconomic imbalances: large imbalances on both its fiscal and the external accounts; large and rising stocks of public and external debt; and weak external competitiveness. This was largely because wages increased more rapidly than what productivity growth would allow. Added to this was an onerous and unsustainable pension system with a weak institutional framework. These factors made Greece particularly vulnerable to sudden shifts in market confidence and increased risk aversion among investors. They were exacerbated by the global crisis and the collapse of liquidity in international financial markets.

The crisis in effect originated in the manifest mismanagement of the monetary windfall enjoyed by Greece and other peripheral countries when they adopted the euro. After Greece joined the euro in 2001, it could borrow at much lower interest rates, despite its deteriorating competitiveness and weak public finances. In retrospect, however, these benign conditions fed a build-up of systemic risk. In the decade before the crisis, this windfall fuelled an unsustainable demand boom mainly through an overly risky leverage and proclivity to short-term financing, mostly from abroad. Encouraged by the perceived elimination of currency and country risks, Greece used cheap funding to finance its fiscal and current account deficits. These increased, accordingly, to unsustainable levels. Conditions in the euro area during this period facilitated such lending, despite a build-up of unsustainable fiscal and external deficits. This meant that Greece could delay tough policy measures and structural reforms that had been rendered necessary and could have proved inevitable if cheap and abundant funding had not been readily available during the 2000s.

The Greek crisis started in late 2009, precipitated by the global recession, the rising debt level, combined with a weakening economy and the constraints imposed by the single currency, particularly the lack of monetary policy flexibility. Eruption of the crisis was triggered by revelations that previous data projections on fiscal deficits and public debt levels had been underreported by the Greek government, notably that the official projection for the 2009 budget deficit was less than half the final value as estimated in 2010. The 2009 public debt was also finally raised to a level of about 11 per cent higher than previously reported.

The crisis brought the country to the verge of bankruptcy. This led to loss of confidence in the Greek economy, as indicated by a widening of the

1 Historical background: Build-up of critical vulnerabilities in the Greek economy

A long history of macroeconomic mismanagement

On 1 January 2001, Greece joined the euro area as its twelfth member, after attaining a high degree of economic convergence. This allowed the country to satisfy the criteria set under the Maastricht Treaty and to qualify for the adoption of the single European currency, the euro. Convergence represented a significant achievement, considering the country's long history of macroeconomic imbalances and serious structural weaknesses. This achievement followed several years of determined and often difficult policy efforts, which led to a substantial improvement in Greece's economic performance.

This introductory chapter provides a historical overview of Greece's economic performance and policies and briefly reviews broad features of the historical background. The chapter discusses the period from 1974 to 1979, during which Greece experienced a weaker economic performance with rising inflation, a serious deterioration of the balance of payments and a slowdown in growth. This pattern of economic developments created problems for subsequent years. This review discusses the mounting macroeconomic imbalances and stagflationary trends during 1980-1985; the 1985-87 stabilisation programme; and the re-emergence of the progress, in the later 1990s, towards fulfilment of the conditions for Greece's adoption of the single European currency. The discussion also brings to surface remaining vulnerabilities and

ANNEX
Overview of the sovereign debt crisis and its aftermath: with figures and tables
The adjustment process and outcomes

Introduction

The sovereign debt crisis of 2009-2010, with the severe, prolonged and worrisome recession that it carried in its trail, represented the worst shock to the Greek economy in generations. In this book, we have described and tried to explain, in detail, how and why the crisis occurred. We have also tried to account for the economic devastation occasioned by this crisis, as well as steps that Greece, its European partners and the IMF were compelled to take with a view to pulling the ailing Greek economy out of this terrible mess. In this Annex, we present an overview of the Greek sovereign debt crisis and its aftermath. We do so with the help of figures and statistics. We believe that the story can best be told visually, with greater precision, as well as with the help of statistical figures. A concise overview of the crisis and of the devastating damage that followed cannot, of course, convey all the several complexities and details of the crisis itself or the government's policy response. However, this brief overview, assisted by figures and tables, captures the fundamental economic characteristics of one of the worst crises in Greek economic history. It illustrates moreover the considerable measure of macroeconomic stability that both Greece and its European partners have ultimately achieved, largely thanks to a decisive, though only partially successful and politically unpopular, policy response.

The build-up of economic imbalances in the run-up to the crisis

As we have previously seen, when Greece became the 12th member of the euro area on 1 January 2001, its economy and finances were in appropriate shape. However, thereafter gradually the economic situation deteriorated over the following eight to nine years. Macroeconomic policy became highly procyclical, using cheap foreign borrowing to finance a significant expansion of spending. A lax compliance record with the Stability and Growth Pact and an unprecedented expansion of credit, largely driven by Greece's financial integration upon entry into the euro area and a consequent increase in the availability of credit and financial assets, played a significant role in amplifying internal and external economic imbalances in Greece.

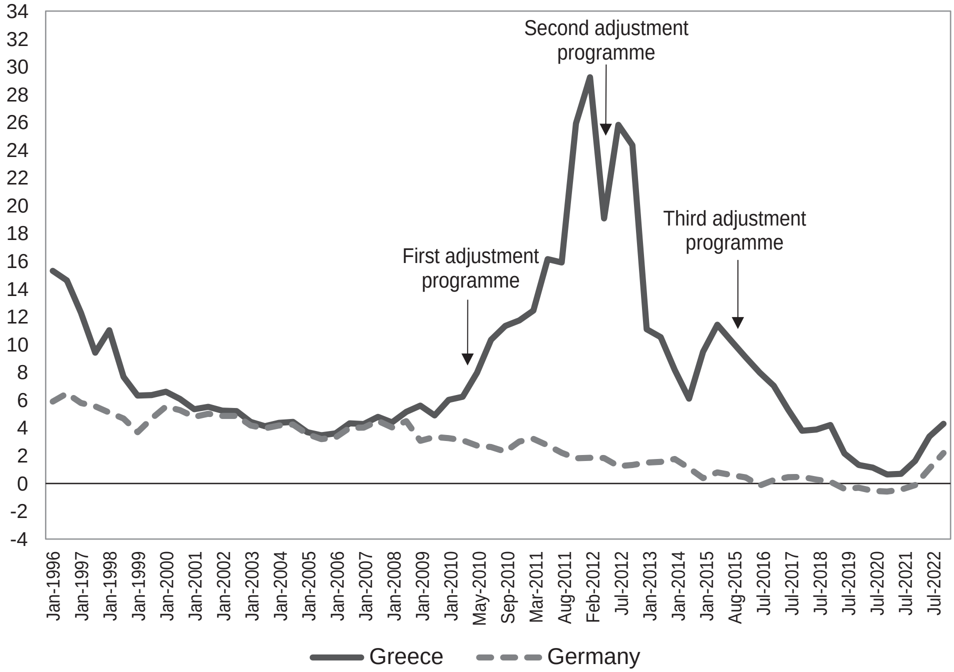
From its entry into the euro area, Greece experienced an economic boom. It was fuelled by low interest rates, loose global credit conditions and an expansionary fiscal policy. Adoption of the euro, low interest rates and loose global credit conditions allowed Greece easy access to foreign borrowing. This financed a significant expansion of government spending. No longer had bond markets to worry about high inflation or an exchange rate risk. Accordingly, borrowing costs fell sharply (Figure 1).

Robust domestic credit growth (Figures 2 and 3), following low interest rates and financial liberalisation, also served to boost household consumption and activity in the housing market.

This took place through an accumulation of foreign liabilities (Figures 4 and 5), which ensued largely because of a surge in borrowing from the banks. This extraordinary credit expansion mainly concerned private businesses and households (Table 1).

After 1998, the rapid expansion of bank credit, together with the prospect of integration into the euro area, was made clear by the fact that, according to Bank of Greece data, total loans more than tripled between 1998 and 2008 (from 80.4 billion euros to 270.3 billion; see Figure 3). While bank loans to general government dropped by more than 11 per cent, loans to firms increased almost fourfold during the same period. Over this same period, however, most impressive was an increase observed in household loans (more than twelve times). The private

Figure 1. Ten-year government bond yield for Greece and Germany
(per cent)



Source: Eurostat, provided by the ECB

sector debt reached 111.5 billion euros in 2008, up from only 9.2 billion in 1998. Thus, private debt expanded at a much faster pace than public debt (Table 2).

Therefore, the first decade of Greece's participation in EMU was characterised by robust growth, accompanied by high wage increases, a divergence in unit labour cost and price inflation, as well as very sizeable fiscal and current account deficits. Real GDP growth averaged 4 per cent a year from 2000 to 2007 (Figure 6), against 2 per cent for the euro area. Thus, Greece's income difference from the euro-area average was reduced from 25 to 10 per cent. Evidently, this extraordinary growth performance was essentially based on unsustainable drivers. The country's economic boom was largely propelled by large foreign-funded fiscal deficits, as well as by an expansion in the non-tradable sector private spending. This enabled aggregate demand to outpace potential output. In other words, thanks to the lower interest rates and easier credit conditions that followed the adoption of the euro, Greece

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