The Eurozone Crisis, Greece, and the Experience of Austerity

A conference organized by the Levy Economics Institute of Bard College with support from the Ford Foundation

Minsky Meets the Mediterranean

Megaron Athens International Conference Centre
November 8–9, 2013

Levy Economics Institute of Bard College

Jan Kregel

Alternative Interpretations of the Greek Crisis

- **Was it a traditional Minsky Crisis?**
  - the result of an endogenous process in which stability induced financial fragility?
  - with sustained, stable expansion under the Euro leading to declining cushions of safety?
- **Or was it a "Washington Consensus" Crisis?**
  - Similar to Latin American Crises of the 1990s?
  - Caused by stabilisation policy required for entry into the Eurozone
  - and aggravated by external capital flows?

#1: A Minsky Crisis?

- Greek Macro data was stable and positive from 2000 through 2009
  - Stable growth rate near 5%
  - Rising per capita incomes
  - Stable inflation rate around 3%
  - Declining unemployment rates
  - Stable debt to GDP ratio just above 100%
  - Rising trend of exports,
  - Slow reduction in current account deficit
  - Despite rising capital inflows
  - And interest rate convergence
  - Rising labour costs
  - BUT: EU record improvement in labour productivity

Declining Cushions of Safety?

- <u>Government's Euro debt no longer sovereign</u>
  - creditworthiness determined by fiscal balance.
  - 2009 deficit revision demoted Greek debt from Speculative to Ponzi
  - the rising (hidden) government deficit represented a de facto decline in the cushion of safety on government debt service

Levy Economics Institute of Bard College

Declining Cushions of Safety?

- Basle II: sovereign debt zero risk-weighting
- Joining Euro eliminated currency risk on Greek debt
- Made interest arbitrage attractive to EU banks and led to declining spreads
- And a reduction in foreign banks' cushion of safety on Greek exposures to near zero
- Unable to cover losses induced by the announcement of the new fiscal deficit number

The Mediterranean Minsky Moment

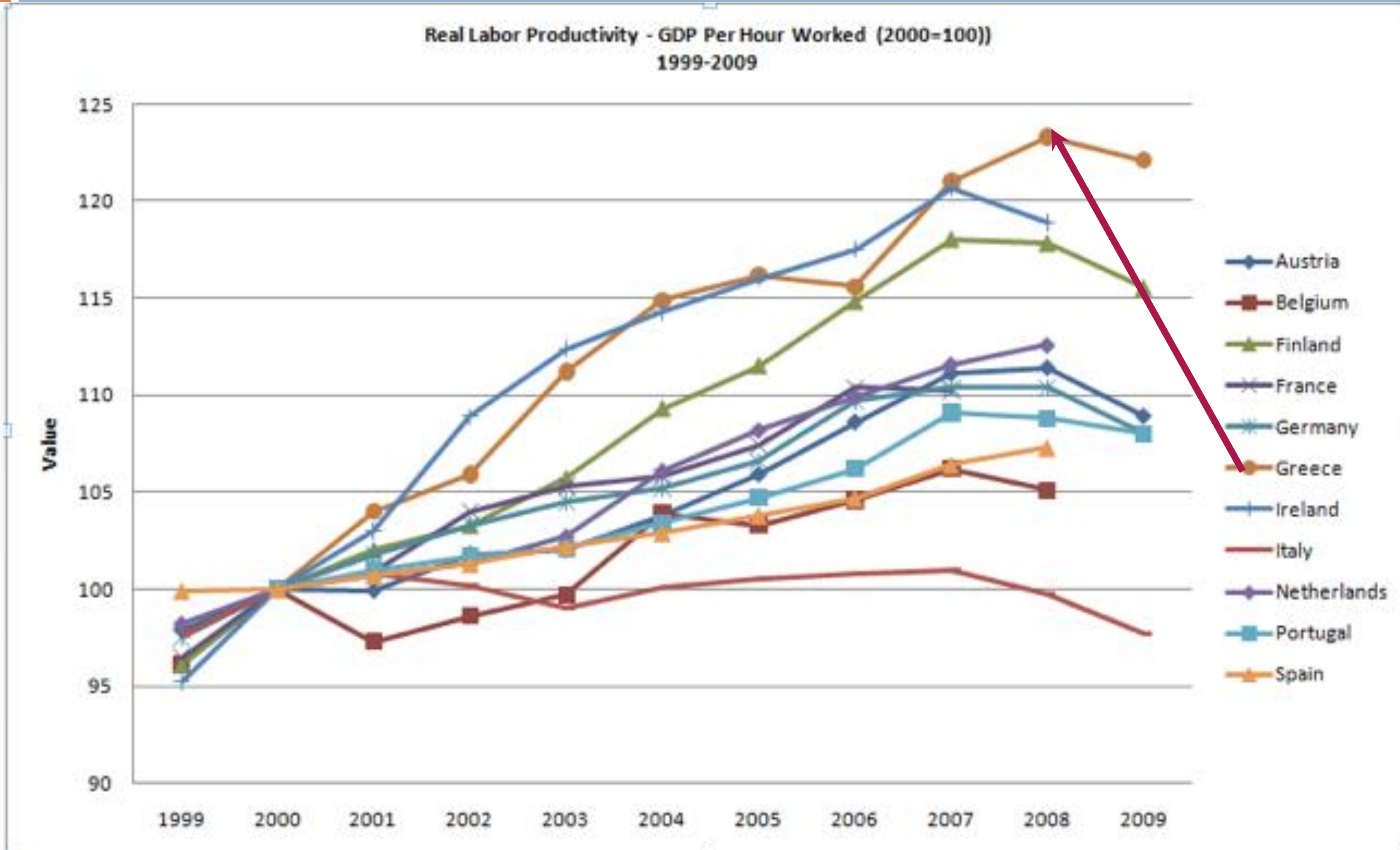
- **Stable scenario shocked by two events**
  - Greece's budget deficit revised from 3.7% to 12.7%, and eventually 13.6%
    - Over four times the Stability and Growth Pact target
  - The tripling of interest rates on Greek debt by the middle of 2010
  - Collapse in the value of Greek Debt in Greek and Foreign Bank Portfolios

The Mediterranean “Minsky Moment”

- The result was a traditional Minsky-Fisher debt deflation process in which
  - financial institutions were no longer willing to roll over maturing debt
  - investors “sold position to make position”
  - which put additional pressure on bond prices and led to ballooning interest rate spreads
- The rise in rates meant that debt service became a larger contributor to the deficit than the primary deficit
  - i.e. debt service would rise faster than tax yields could be increased

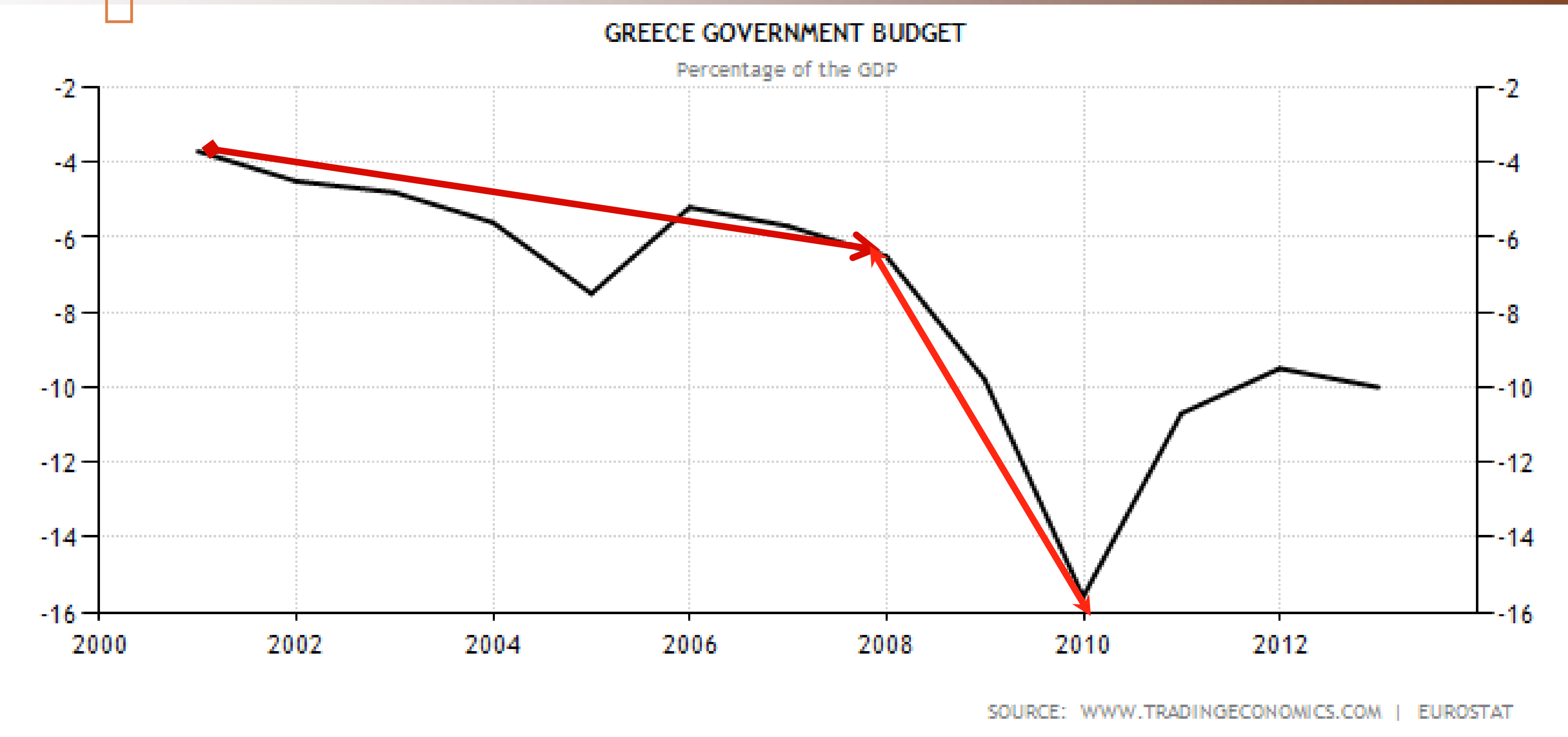
Policy Response to Minsky Crisis

- **Traditional Response to a Minsky Crisis:**
  - Central Bank lending to support of asset prices
  - Government deficit stimulus to support incomes
- Both were impossible under EU Treaties
  - ECB could not act as Last Resort Lender
    - Eventual ad hoc ECB action to reduce spreads
  - No EU budget stimulus to provide deficit support
    - Ad Hoc EU lending institution created to replace private financial institution lenders
  - But conditioned on Greek government action to create a primary surplus



Minsky Conference in Greece

Budget Deficit shock from 6% to 13%



Yield curve jumps up and goes flat

Πίνακας IV.25. ΑΠΟΔΟΣΕΙΣ ΟΜΟΛΟΓΩΝ ΤΟΥ ΕΛΛΗΝΙΚΟΥ ΔΗΜΟΣΙΟΥ (ποσοστά % ετησίως, μέσοι όροι περιόδου)

Table IV.25. YIELDS OF GREEK GOVERNMENT BONDS (percentages per annum, period averages)

Περίοδος Period	3 ετών 3-year	5 ετών 5-year	7 ετών 7-year	10 ετών 10-year	15 ετών 15-year	20 ετών (1) 20-year (1)	30 ετών 30-year
Δεκ./Dec.	3,72	4,67	5,01	5,49	6,10	-	6,11
2010 Ιαν./Jan.	4,72	5,40	5,61	6,02	6,50	-	6,36
Φεβρ./Feb.	5,92	6,30	6,21	6,46	6,58	-	6,47
Μάρτ./Mar.	5,51	5,84	5,83	6,24	6,45	-	6,47
Απρ./Apr.	7,91	7,87	7,87	7,83	7,46	-	7,08
Μάιος/May	8,28	8,59	8,39	7,97	8,28	-	7,69
Ιούν./Jun.	9,41	9,50	9,57	9,10	9,68	-	9,11

Impact of the Euro/Basle induced capital inflows?

- **Differential Impact of Capital Flows:**
- “Northern” economies attract investments in “productive” sector
- “Southern” economies attract investment in real estate
- positive relationship between FDI and trade balances for “North”
- negative relationship for the “South”

- **Accentuated Divergence After Introduction of the Euro:**
- After 1999 substantial rise in the net inflow of FDI in the euro area.
- At industry level:
  - positive relationship between FDI in manufacturing sector and the trade balance in the North
  - negative relationship between FDI in non-manufacturing sector and trade balance for South
  - When FDI inflows are channeled to the productive/tradable (unproductive/non-tradable) sector, this leads to substantial improvement (deterioration) in productivity and competitiveness in the long run.

#2: A Latin American Crisis?

- After the Lost Decade of the 1980s many highly indebted Latin American countries introduced SAPs (structural adjustment policies) based on the "Washington Consensus".
- Examples: Mexico, Brazil, Argentina
- All of these countries exhibited financial crises in the 1990s as a result of these policies

Similarities to SAP financial crisis

- Exchange rate anchor
  - Argentina: Currency Board, Greece: Euro
- Price stabilisation
  - declining import prices
- (real) Overvaluation of the currency
  - Loss of competitiveness of domestic industry
- Rising foreign capital inflows
  - little increase in productive investment
  - increased lending to households for consumption and real estate
- Producing rising external private and public indebtedness

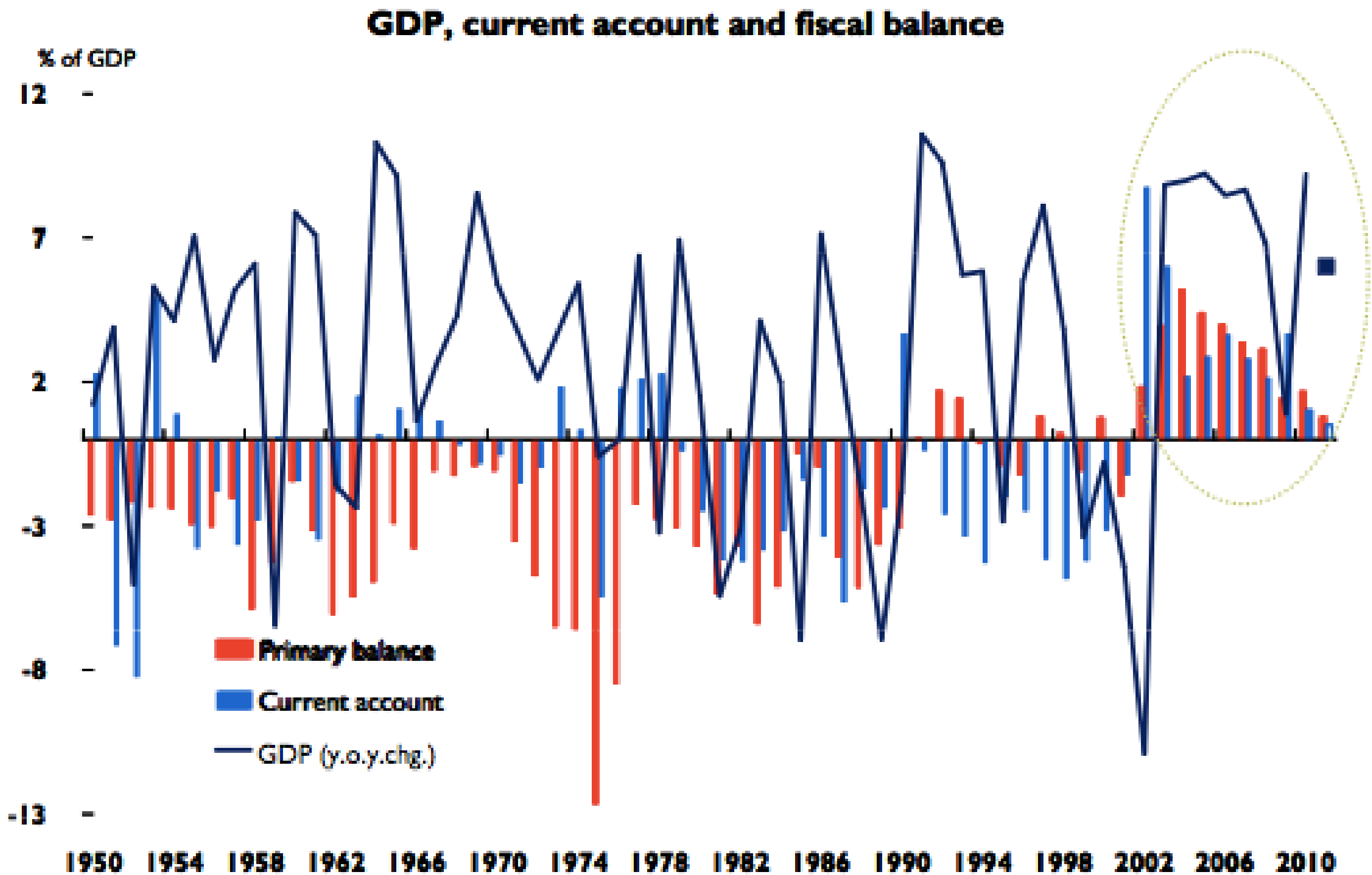
Policy to build confidence?

- Increase fiscal surplus to convince foreign lenders of the ability to meet debt service
  - Debt restructuring to reduce interest costs
  - Reduce Government budget expenditures
  - Raise Taxes
  - Cut government wages
- Result: Income fell and tax yields fell faster than expenditures could be cut
- Fiscal deficits and debt/GDP ratio continued to increase
- Foreign Capital left and economy collapsed

What did Argentina do?

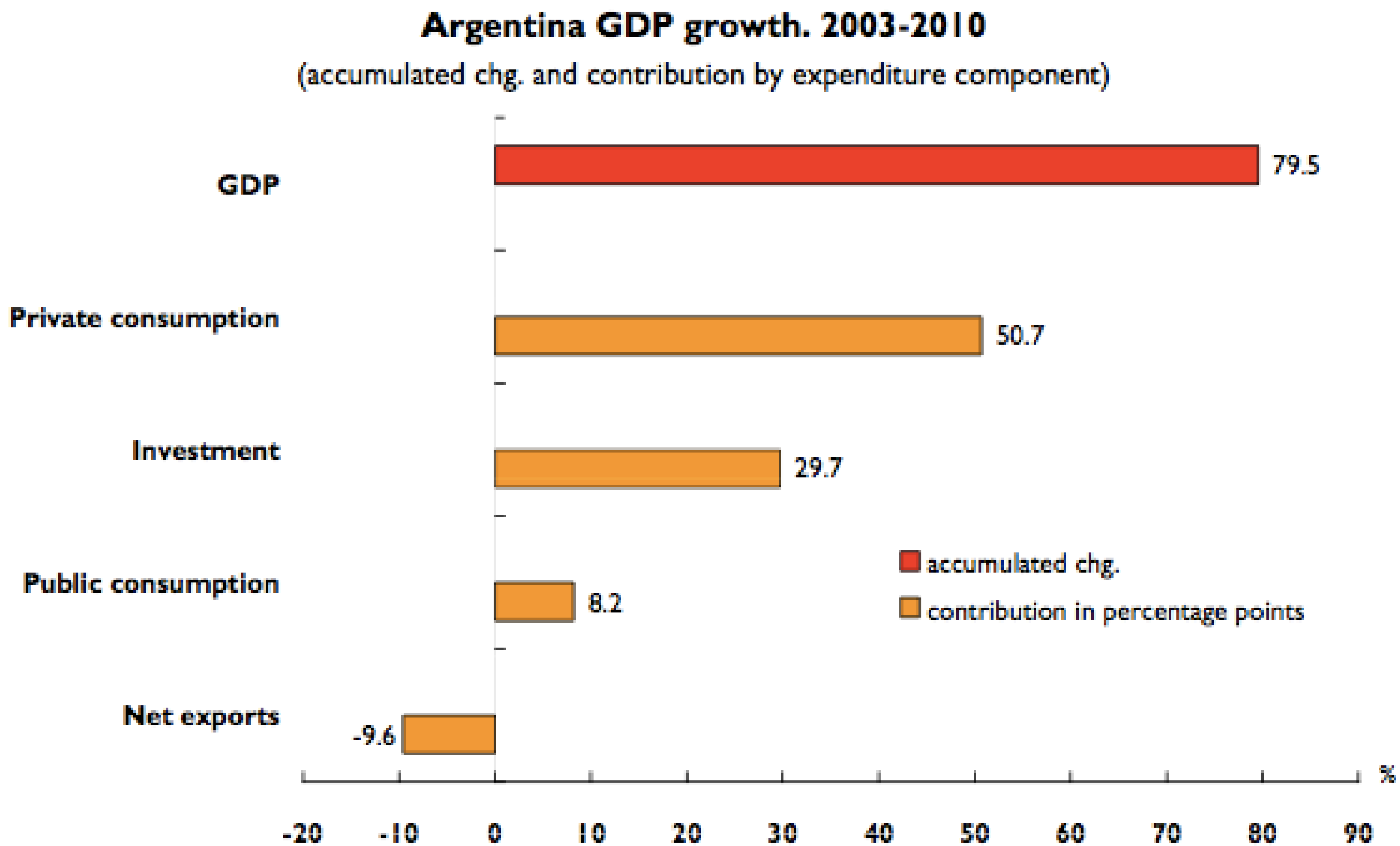
- Provinces introduced parallel currencies
  - Patacones
- Federal Government Repealed Convertibility Law
  - Devaluation of exchange rate
  - Rising exports
  - EXTERNAL SURPLUS
- Defaulted on Government Debt
- FISCAL SURPLUS
- Increased wages
- Shift from export-led recovery (2001-3) to domestic demand-led sustained growth (2003-2010)
- Rapid Recovery of income and employment

Fiscal balance has been supported by domestic demand, simultaneously Argentina has experienced sustained external surpluses. The period 2003-2010 is the only one in Argentine history that combined twin surpluses and high growth.



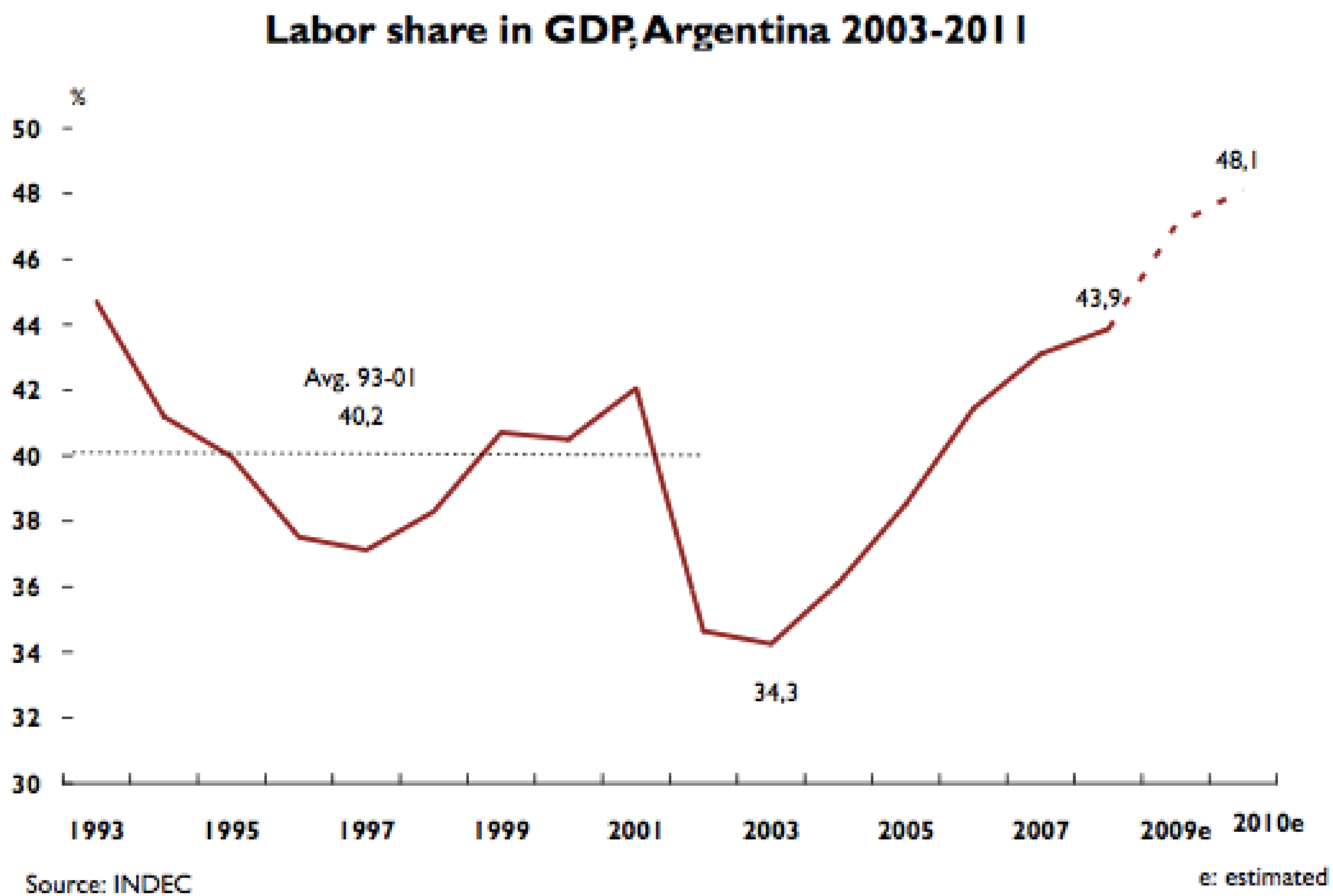
Source: BCRA from Treasury Secretariat and "Dos siglos de economía argentina" of OJ Ferreres.

Economic growth: domestic demand has been the main driver of growth



Source: INDEC

Economic growth and the role of domestic demand: labor share in GDP



Conclusions: What kind of Crisis?

- 1. A Minsky Crisis: Yes
  - Introduction of the Euro led to declining cushions of safety and Ponzi finance
- 2: A “Washington Consensus” Crisis: Yes
  - The policies imposed on Greece by the Troika were similar to Structural Adjustment Policies that produced collapse in Argentina
  - Did nothing to restore fiscal or external balance
- 3. How to engineer an Argentine Recovery in Greece within the EU
- Austerity will never lead to Recovery

www.levyinstitute.org

Levy Economics Institute of Bard College