CONFERENCE PROCEEDINGS

THE EUROZONE CRISIS, GREECE, AND THE EXPERIENCE OF AUSTERITY

Athens, Greece

November 8–9, 2013

LEVY ECONOMICS INSTITUTE
of Bard College

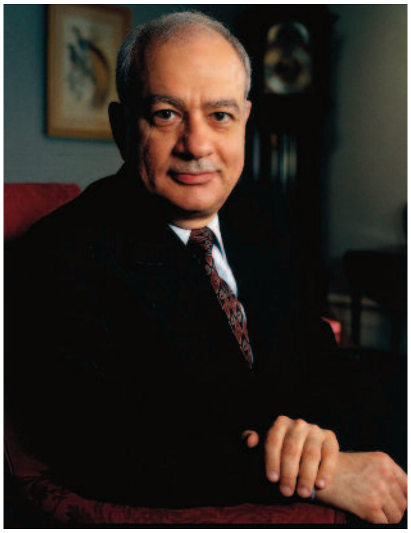
A conference organized by the Levy Economics Institute of Bard College with support from the Ford Foundation

FORDFOUNDATION

Contents

These proceedings consist of edited transcripts of the speakers' remarks and summaries of session participants' presentations.

Foreword



I am delighted to welcome you to the conference "The Eurozone Crisis, Greece, and the Experience of Austerity," organized by the Levy Economics Institute with support from the Ford Foundation. This conference is one of the public outreach activities of the joint Ford–Levy Institute Project on Financial Instability, which draws on Hyman Minsky's extensive work on the structure of financial systems to ensure stability, and on the role of government in achieving a growing and equitable economy.

Among other key topics, the conference will address the challenges to global growth and employment posed by the ongoing debt crisis in the eurozone, the impact of austerity on output and employment, the ramifications of the credit crunch for economic and financial markets, the larger implications of government deficits and debt crisis for US and European economic policies, and central bank independence and financial reform.

I trust you will enjoy the presentations that follow. As always, your comments and suggestions are welcome.

Dimitri B. Papadimitriou
President, Levy Economics Institute

Program

Friday, November 8

8:00–9:15 a.m. — **REGISTRATION**

9:15–9:30 a.m. — **WELCOME AND INTRODUCTION**

Dimitri B. Papadimitriou, *President, Levy Institute*

9:30–11:00 a.m. — **SESSION 1**

Europe at the Crossroads: The End of Muddle-through

Moderator: Liz Alderman, *European Economics, Business, and Finance Reporter,* The New York Times

Philippe Gudin de Vallerin, *Managing Director and Chief European Economist, Barclays*

Ebrahim Rahbari, *Director, European and Global Economics, Citigroup*

Frank Veneroso, *President, Veneroso Associates, LLC*

11:00 a.m. – 12:00 p.m. — **SPEAKER**

Már Guðmundsson, *Governor, Central Bank of Iceland*

"Iceland's Crisis and Recovery: Are There Lessons for the Eurozone and Its Member Countries?"

1:30–3:15 p.m. — **SESSION 2**

Will the Periphery Survive in the Euro?

Moderator: Yannis Aggelis, *Senior Editor,* Kefalaio*; Editor,* Capital.gr

Rainer Kattel, *Professor and Chair, Innovation Policy and Technology Governance, Tallinn University of Technology*

Jan Kregel, *Senior Scholar, Levy Institute; Professor, Tallinn University of Technology*

Elias Kikilias, *Research Director, National Centre for Social Research, Greece*

L. Randall Wray, *Senior Scholar, Levy Institute; Professor, University of Missouri–Kansas City*

3:45–4:00 p.m. — **SPEAKER**

Alexis Tsipras, *Leader of the Opposition (SYRIZA), Hellenic Parliament*

4:00–5:00 p.m. — **SPEAKER**

Yves Mersch, *Member, Executive Board and General Council, European Central Bank*

"Intergenerational Justice in Times of Sovereign Debt Crises"

5:00–7:00 p.m.

SESSION 3

The Financial System in the Eurozone and Greece: Dysfunctional or Built to Last?

Moderator: Matina Stevis, *European Economics Correspondent,* The Wall Street Journal

Gerasimos Arsenis, *President, ADGI–INERPOST*

Emilios Avgouleas, *Chair, International Banking Law and Finance, School of Law, University of Edinburgh*

Dimitri Vayanos, *Professor of Finance and Director, Paul Woolley Centre for the Study of Capital Market Dysfunctionality, London School of Economics*

George S. Zavvos, *Legal Adviser, Legal Service, European Commission; former Member of the European Parliament and European Commission Ambassador*

Saturday, November 9

9:00–10:30 a.m.

SESSION 4

A Union of Austerity or a Union of Growth?

Moderator: Michalis Panagiotakis, *Journalist,* Avgi

Robert W. Parenteau, *Research Associate, Levy Institute; Sole Proprietor, MacroStrategy Edge*

Jörg Bibow, *Research Associate, Levy Institute; Professor, Skidmore College*

10:30 a.m. – 12:30 p.m.

SESSION 5

The Challenge of Unemployment: Can Current Policies Work?

Moderator: Christina Kopsini, *Editor, Labor Market and Employment Issues,* Kathimerini

László Andor, *Commissioner for Employment, Social Affairs and Inclusion, European Commission*

Duncan Campbell, *Director, Policy Planning in Employment, International Labour Organization*

Massimiliano La Marca, *Economist, International Labour Organization*

Rania Antonopoulos, *Senior Scholar, Levy Institute*

Maria Karamessini, *Professor, Panteion University*

1:30–3:30 p.m.

SESSION 6

Growth, Jobs, and Well-Being in Greece and Europe

Moderator: Nikos Xydakis, *Editor,* Kathimerini

Terrence McDonough, *Professor of Economics, National University of Ireland, Galway*

Louka Katseli, *President, Social Pact Party, Greece; Professor of Economics, University of Athens*

C. J. Polychroniou, *Research Associate and Policy Fellow, Levy Institute*

David Stuckler, *Senior Research Leader in Sociology, Oxford University*

3:30–4:30 p.m.

SPEAKER

Lord Robert Skidelsky, *Emeritus Professor of Political Economy, University of Warwick*

"The Experience of Austerity: The UK"

5:00–6:30 p.m.

SESSION 7

The Greek Experience of Austerity

Moderator: Stavros Lygeros, *Author, and Journalist,* Real News *and Real FM Radio*

Giorgos Argitis, *Research Associate, Levy Institute; Professor, University of Athens*

Gennaro Zezza, *Research Scholar, Levy Institute; Professor, University of Cassino, Italy*

Dimitri B. Papadimitriou, *President, Levy Institute*

6:30–8:00 p.m.

SESSION 8

Rethinking Europe's Future

Moderator: Alexis Papahelas, *Executive Editor,* Kathimerini

Kerstin Bernoth, *Scientific Adviser to the Board, DIW Berlin; Professor of Economics, Hertie School of Governance*

Martin Hellwig, *Director, Max Planck Institute for Research on Collective Goods*

Loukas Tsoukalis, *Professor, University of Athens; Visiting Professor, King's College, London; President, ELIAMEP*

Yannis Dragasakis, *MP (SYRIZA) and Fourth Vice President of the Hellenic Parliament*

Welcome and Introduction

DIMITRI B. PAPADIMITRIOU
President, Levy Institute

I want to welcome you to this conference organized by the Levy Economics Institute, on the other side of the Atlantic, in New York. I want to thank the Ford Foundation and Program Officer Leonardo Burlamaqui, not only for the financial support, but also for his guidance in the project that the Ford Foundation is supporting at the Levy institute on the reregulation of financial markets and institutions. Thanks are also due to the many media sponsors publicizing this event. And my sincere thanks to Chronis Polychroniou, who conceived the idea for this conference, for his tireless efforts in working out all the logistical details here in Athens.

This conference is the outcome of the Institute's project on monetary policy and financial structure, which is headed by my longstanding colleague Jan Kregel. Jan inherited this project from Hyman Minsky, who . . . initiated it when he joined the Institute as a distinguished scholar in 1990. We have seen over the recent past the immense recognition of the contributions that Hyman Minsky made, and that recognition has come not only in the United States and in Europe, but also throughout the world. . . .

The Levy Institute was established in 1986 as a unit of Bard College, located in New York, USA. It is an independent, nonpartisan think tank, and it encourages diversity of opinion in the examination of pressing economic issues . . . , not only in the United States, but also in the rest of the world. We are concerned with financial instability; the capital development of the economy; the purchasing power of workers; growth and unemployment; the distribution of income, wealth, and well-being; and gender equality. Our focus is on generating viable, effective public policy responses to pressing economic problems, and we bring together academics, business leaders, policymakers, and the public to debate, and at times contest, dominant ideas in the hope of serving the public interest. We invite you to take a look at the various Institute publications that are available outside, most of which relate to the topics that will be discussed during this conference. Also, we ask you to take a look at our website (and perhaps subscribe to the *Levy News*), which, incidentally, averages about half a million page views per month.

The purpose of this conference is to extend the discussion relating to the crisis in Greece and the eurozone to a wider audience interested in understanding the root causes of the crisis from the perspective of careful research and analysis. My colleagues and I have argued, as early as 2010, that the diagnosis of the crisis and the corrective actions proposed by the troika and followed by three successive governments in

Greece were ill conceived. As we hope to show tomorrow—for instance, through our specially constructed stock-flow consistent macroeconomic model for Greece—the prospects for the country are not encouraging should business continue as usual. The simulated trajectories of the financial balances of the three main sectors of the economy—that is, the private, the public, and the external—over the next three years are very different [from] those suggested by the troika and the Greek government. We pride ourselves on our models' capacity to offer projections . . . that are much more accurate than those of conventional models. Unfortunately, those conventional models are being used by the troika as well.

High public deficits and debt, together with bad policies, have created unsustainable and unstable markets. The ineffective and disastrous austerity policy responses and miscalculated fiscal multipliers have made matters worse, delivering catastrophic levels of unemployment, deepening recession, declining fortunes, and high levels of poverty and despair. Periods of euphoria combined with accommodative monetary and fiscal policies helped increase both the government's and the private sector's borrowing and debt linked to the deterioration of the balance of payments. Indeed, there is a macroeconomic identity making the internal (that is, the private and public sectors) and the external (the current account) balances [net to zero]. Although this identity is not a theory, it informs policy. The importance of this identity will be analyzed in considerable detail tomorrow, when we discuss the Levy Institute model for the Greek economy and what we expect will happen in the next three years should the present course of austerity continue.

The introduction of the euro was based on member countries' convergence on domestic inflation, represented by an inflation target, a government deficit, and debt-to-GDP ratios, disregarding the widely different domestic economic and monetary conditions across countries. Although convergence of the monetary variables was achieved, it came with increasing divergence of real economic performance—for instance, in productivity, labor costs, and real rates of return across member countries. This divergence surfaced in interregional trading balances financed by increasing cross-border lending within the eurozone. Furthermore, because of inflation and interest rate convergence, financial institutions did not recognize risk differentials across member-states. The relative risks of individual countries issuing sovereign debt, which should have been dependent on the real economy of each country, disappeared. Ultimately, this meant that the ability to repay debt became more and more dependent on the ability to borrow to meet interest and principal payments. This process, of course, for those of you who have read and know about Minsky's work, is nothing more than a Ponzi scheme—a house of cards. As lenders came to recognize the inability of the borrower to service debt, they withdrew support, and financial instability became a financial crisis. This, of course, can be attributed to the faulty structure of the eurozone, a topic that will be the focus of many of the presentations that follow.

A year ago, we organized a similar conference in Berlin with the purpose of entering into a dialogue with government representatives from Germany and [other] North European countries, the European Central Bank, and the United States Federal Reserve, along with academicians and business leaders concerned with the continuing crisis, the ineffectiveness of policies dealing with the crisis in the eurozone, and the disastrous results that have ensued in the periphery member-states. [At that conference,] it was pointed out that [the argument] that the Greek crisis exposed the profligacy of the Greek government and its citizens . . . ran contrary to the evidence. At the onset of the crisis, Greece had one of the lowest per capita incomes in the European Union, and its social safety net was modest compared to the rest of Europe. But reading the press at the time, one was given the impression that the Greeks enjoyed one of the highest standards of living in Europe, while the frugal Germans were forced to pick up the bill. By contrast, Germany and France, for example, spend more than double the Greek level on social protection benefits. Ireland spends more on social protection than the supposedly profligate Greeks. If we took into account, as many have argued, that corruption ran rampant in Greece, its administrative costs were actually lower than those of the German, French, and Irish bureaucracies. Even spending on pensions, before they were decimated, was lower than in other European countries.

Since the Berlin conference, eurozone sovereign debt has continued to increase, despite the harsh austerity imposed by Berlin and Brussels. [The] dynamics, of course, are complex, but the debt level of the South European periphery is accumulating at an accelerating rate. For instance, in Greece it is about 170 percent of GDP; when the crisis began in 2009, it was 125 percent of GDP. Italy's [debt level] is presently at about 130 percent of GDP; Portugal, 127 percent; and Ireland, 125 percent. What is clear, however, is that austerity means that falling wages and pensions reduce consumption and retail sales and hence government revenues, necessitating higher taxes that further reduce income and output, thus continuously increasing the debt-to-GDP ratio. For the eurozone as a whole, public debt is at 94 percent of GDP—much higher than the artificial 60 percent in the Maastricht Treaty and the level that Germany insists be followed. As the bigger troubled economies like Spain and Italy are also under the grip of austerity, the entire continent could ultimately see government revenues collapse. Worse, exports to neighbors are hurt by a reduction in demand, as has happened in Greece. Lower wages, pensions, and prices in one member country could engender competitive deflation and compound the problem, as each country tries to gain.

What is most remarkable is that the EU's largest exporter, Germany, does not yet appear to recognize that its insistence on fiscal austerity for all its neighbors and promotion of a beggar-thy-neighbor export-led strategy cannot last very long, nor will it be accepted by those charged with running the global economy—as demonstrated by the strong voices coming from Washington recently. Many of us at the Levy Institute suggested early on that what was needed was a way of redirecting demand to the trade-deficit nations—for example, by having surplus nations spend euros on direct investment. Such mechanisms could be set up very quickly under the aegis of European investment banks. We should recall that the great master John Maynard Keynes said that surplus economies either use their surpluses or they lose them. Effective incentives to recycle current account surpluses via foreign direct investment, equity flows, foreign aid, or imports could easily be crafted. These suggestions have, of course, fallen on deaf ears in both Berlin and Brussels.

As we will show tomorrow, the strategy of internal devaluation that has by now achieved a 30 percent reduction in Greece, surpassing the goal of 15 percent, has proved to be detrimental for living standards and for domestic consumption, the most important stabilizing driver of an economy. For Greece, the path of exports, as the evidence shows, was unsustainable before the crisis and is still unsustainable despite a modest increase, which is not sufficient to offset the precipitous decline in private and public consumption. To be sure, exports are important, but domestic demand is crucial. Even China, the largest export-oriented economy, took the necessary steps to increase and stabilize its domestic demand after the global collapse of exports, and this should be the emphasis for Greece and the other countries of the European South.

The government has recently begun celebrating a primary budget surplus that it says should be achieved this year, and is on a media campaign to convince Greek citizens of the importance of this milestone.

Even if this primary surplus were real [and did not involve] the use of creative accounting, one should ask, what was the cost of accomplishing it? I frequently hear the word "*ατυχημα*" (accident) being used, but I am not certain what it means [in this context]. Does it mean that the government might be unable to convince Berlin and Brussels that no additional austerity measures can be implemented to cover the projected 2014 budget gap? Or does it mean that the projected revenues and/or spending cuts fall short of the targets? In my view, a responsible government cannot be guided by happenstance.

What is to be done, then? The South European nations, and especially Greece, as all of us know, need a pro-growth and employment policy. As we will show tomorrow, there are ways that these goals can be achieved.

All of what I have said up to now is drawn from the work of Hyman Minsky and Wynne Godley, both distinguished scholars at the Institute for many years. Minsky, of course, is known for developing the financial instability hypothesis and documenting the important role of a big government and a big bank. Godley was a master forecaster and the architect of the macroeconomic stock-flow consistent models that simulate the trajectories of the three main sectors with peerless accuracy, which I referred to earlier. This conference is therefore, in a way, a tribute to their contributions to economics and to us.

Finally, it is our sincere hope that this conference will present a true picture of the crisis in the eurozone and Greece and the experiences of austerity, and . . . provide new ideas for an exit from this crisis, in contrast to the strategies that are in place now.

Thank you very much for coming, and enjoy the conference.

Speakers

MÁR GUÐMUNDSSON

Governor, Central Bank of Iceland

Iceland's Crisis and Recovery: Are There Lessons for the Eurozone and Its Member Countries?

Let me first thank the Levy Institute and the local organizers for inviting me to speak here today about Iceland's crisis and recovery and the potential lessons for others—in particular, the eurozone and its member countries—and enabling me to come to Athens, actually for the first time, to see this magnificent, historic city.

I also want to thank you for the kind words of [introduction]. I should mention that I was at the Bank for International Settlements in the Monetary and Economics Department from 2004 to 2009, so I was not in Iceland when the crisis struck—that is probably why I am standing here today. This is a very rich history with lots of twists, and I am not going to be able to cover some aspects of it. Icelanders have a long literary tradition. . . . Snorri Sturluson, who was an author in Iceland during the 13th century, . . . wrote many books that are now part of our literary heritage. He wrote about things that happened in the Nordic countries and in Iceland, and also about the Norwegian kings 200 and 300 years earlier. . . . We are now beginning to write the experience that we went through during the crisis, but I bet that we will still be writing about [it] after 100 years, and hopefully getting better and better at [writing about the experience]. Hopefully, we will be better at it than running cross-border banks—at least I hope, for all of us.

Let us cast our minds back . . . to the autumn of 2008. In that autumn, almost 90 percent of Iceland's banking sector failed in the course of one week. In terms of magnitudes, . . . there are not many parallels, at least not in developed countries. If you look at the bankruptcy of the three cross-border banks that the question was about, this is the third-biggest corporate failure in the history of mankind, if you take them together, after Lehman Brothers and WorldComm, I think. And this occurred in one of the smallest countries in the world. That has created huge, huge complications, as I will come to in a minute.

The losses that took place were shared widely across borders. It was not only Iceland that was hit; it was, to a very significant degree, big parts of Northern Europe. Maybe in some sense that was good for Iceland, because if Iceland had borne on its own all the losses, the country would be bankrupt by now. But what is important to realize is that before these banks collapsed in the wake of the collapse of Lehman Brothers, Iceland was already in a currency crisis, and was on its way into a recession after an unsustainable boom during 2005–07 that had nothing to do with the collapse of these banks. Of course, the collapse of these banks made it much worse. . . . At the time, many expected a deep recession, and there was widespread talk that the sovereign might default on its obligations. Just to quote Gordon Brown, he said, "Iceland is bankrupt."

Where are we now? There is no talk of a sovereign default. The sovereign has investment-grade ratings, and the sovereign has tapped the foreign capital markets twice since the crisis. We have been recovering since the second quarter of 2010, and we have rebuilt a domestically oriented banking system. . . . We are really growing, as predicted in 2013. Iceland is up there somewhere between Japan and Switzerland, and after New Zealand, Australia, and Japan, and that is a good place to be.

How did that happen? I am going to try to explain some of that here. What is important to realize when we think about what I call the recent Icelandic saga, which is basically the economic history of Iceland during the last decade and a half, is that that saga is actually composed of two interrelated substories. One is what I call Iceland's boom-and-bust cycle and the problems with macroeconomic management of small, open, financially integrated economies—a story like we have seen played out, maybe not thousands of times, but hundreds of times, around history and around the globe. And Iceland has done it before. It may have been a bit more extreme on this occasion, but there was nothing in terms of the features that was unique; there was nothing that we hadn't seen before. It was a very familiar story of very strong capital inflows inflated as the crisis in credit grows, a boom that goes into a bust, and all the rest of it.

But the second story was the rise and fall of three "passport" banks that were operating on the basis of EU legislation, or what we call the European "passport." That was absolutely unique—that had never happened before. We had never seen a banking crisis in the European Economic Area [EEA]. We are part of the European Economic Area, which is basically the European Union, Norway, Iceland, and Lichtenstein, which means that these countries are part of a single market. This was the first banking crisis since the single market was formed, and there were unique features that are very important in terms of the lessons [learned], as I will come to in a minute.

Now, these two stories were running parallel, and then they converged in a grand finale in early October 2008. This country is famous for its dramas, and that is usually what happens at the end of the drama: all the threads of the story come together in a grand, tragic finale. In order to understand the consequent economic developments in Iceland, we need to bear this in mind: these are two stories.

In more granular terms, what we were experiencing in 2008 was what you could call one adjustment and three shocks. The adjustment had to do with these unusually large external-internal macroeconomic imbalances in 2005–07, where credit growth peaked at 40 percent [and] the current account deficit was almost 25 percent. There was a huge investment boom in the country, et cetera. The subsiding of this was always going to be associated with a significant slowdown, if not an outright recession, and that had nothing, again, to do with the international economic financial crisis [or] the collapse of Lehman Brothers. Note that the Central Bank of Iceland, from 2006 onward, consistently predicted the recession in 2009. It was not very popular for it, but that is what it did. It said, in 2006, "There's going to be a recession in 2009," and that had to do with this internal investment profile of the country.

But then you have these banks hitting the wall. At first, they faced a certain stop, and the country faced a certain stop, and that was materialized in a currency crisis in early 2008, when the exchange rate fell by something like 26 percent. Then you have the collapse of these banks, where the certain stop turned into a certain reversal. There was a wholesale run on the foreign currency liabilities of these banks, post Lehman. and the foreign currency liabilities were something like three-fourths of the liabilities. That was impossible to manage in light of the fact that there was no international cooperation forthcoming. They [the banks] collapsed, and the exchange rate fell another 26 percent to year-end. Then, finally, the third shock was the global contraction that hit the world economy and then had subsequent effects for Iceland.

So in the course of 2008 you are talking about a 52 percent depreciation that actually took the real exchange rate of the currency—which was, of course, overvalued at that point—something like 30 percent below its historical average. It was a huge undershooting, in that sense, which always happens in currency crises of this magnitude. That was very harmful but also helpful, and I will come to that later in my talk. But in understanding how that affected the country in the short term, one should realize that it hit a private sector that was very, very indebted, and where a very significant part of that debt was either linked to the CPI—the price index—or directly denominated in foreign currencies. That meant that when the currency collapsed by 52 percent, you had a huge balance sheet recession materializing within the country, where debt levels went up in króna terms at the same time as people were losing their jobs and wages were stagnating and falling, et cetera.

This was what happened. In order to design a sensible economic policy response to this, one needed to ask the question, what was the nature of this economic problem? What was it that needed to be addressed? And I have here [four] candidates: First of all, was it unsustainable expenditure imbalances—the current account deficit? Was it overindebtedness—this high indebtedness of the private sector? Was it overextended sectors within the economy—that is, finance and construction? Or was it lack of effective demand?

Of course, it was all of these in some combination. But if you analyze the Icelandic story, and if we were to say that overextended sectors are more like a Hayekian element and overindebtedness is more a Fisherian element, there were more such elements in the Icelandic crisis than there were Keynesian elements.

Iceland is a very small, open economy, and that means that internal effective demand problems are usually less of an issue than in larger economies, and there are these demand leakages through the external accounts and all the rest of it, the scope [of] export-led growth is [greater], et cetera. So the lack of effective demand was more of a temporary result of the crisis than a significant cause of the crisis.

What was the policy response, then? It was basically composed of two elements. The first element had to do with how we dealt with collapsing banks, and that was before the IMF [International Monetary Fund] was officially in Iceland. The second element had to do with the scale of the macroeconomic adjustment and in terms of how we dealt with the banks. These banks were 10 times GDP—so, something like two-thirds to three-fourths, depending on whether you look at the assets or liabilities or in terms of foreign currency. I call them cross-border banks, but they were more probably characterized as off-border banks because a very significant part of the financing was abroad and the investment was abroad as well. But because of how we do the international investment position statistics, all of this is booked through Iceland—gross inflows, gross outflows—but none of those things happened. There were a lot of inflows into Iceland, but part of what was happening was off-border.

In order to save the banks, you didn't only need a capital injection; you needed a huge refinancing of the bleeding asset liabilities, and that was impossible to provide given that our foreign exchange reserves were, with the swaplines, something like 35 percent of GDP. Iceland tried to seek international cooperation, because this was a giant problem, really, in retrospect; because this was caused by the rulebooks of the European Union, and it was caused by the run on dollar liabilities and, in our case, also euro liabilities around the world post Lehman. In other cases, it was sold with the swaplines that were grafted to the ECB [European Central Bank], the Bank of England, Bank of Japan, Bank of Switzerland, which we were not part of.

What we had to do was to say, okay, we have to focus: We cannot save these banks. We have to save the core elements. We have to save the domestic payment system. We have to save the common man's access to his or her deposits. There was a króna run on the banks as well, but [a run] is easy to stop. What you do is provide a blanket guarantee. You can do that in your own currency because the deposits are wrapped up with the withdrawals from the banks. Where do they go? They go into the balance sheet of the central bank, and it can be recycled against collateral. That was quite successful.

So what was done, there was a statement that all deposits in Iceland were secure, … and we carved out new domestic banks from the failing banks. These banks were 1.7 times GDP—still too big, but much smaller than the 10 times GDP that they were before.

The second element, which actually was initiated in November 2008, was the IMF program with the financing of US $5 billion, including bilateral loans with three key goals. One was to stabilize the exchange rate—because, remember, there was a currency crisis with huge balance sheet deficits within the country. In order to stop the recession and have any possibility of a turnaround you needed to do that—you needed to aim for fiscal sustainability (I will come to that in a minute) and rebuild the financial sector. What is important—and what is very important in understanding where we are now—is that the IMF itself proposed comprehensive capital controls as key elements of the program. The reason for that was that after a point there were króna positions in the hands of foreign residents which were a legacy from the current trade of the huge capital inflows that was something like 43 percent of GDP. The sterling balances that the UK had at the end of the Second World War? It took them something like 30 years to unwind, and if that had gone out through a smaller, average market, then the currency would just have already collapsed by 52 percent, but it would have been much more.

I'm going to have a footnote here on one issue because it has been very prominent in the discussion. You might ask, and I am often asked, why was it that the Icelandic government only promised to keep deposits in domestic branches of its banks safe? Why wasn't the blanket guarantee extended to the foreign currency–denominated deposits in the so-called Icesave accounts in branches of one of the banks in the UK and in the Netherlands? The answer is pretty obvious, because promising to protect deposits works only if they are mostly in your own currency; because you can print that currency—of course, technically, you are not printing, but that's the metaphor—and in that way you can deal with it.

But the [resources] of the central bank [totaled only] 2.5 billion euros, and at that point . . . there was no way [the sovereign] could borrow in markets. These were the only assets that we had, whereas the insured deposits, or the Icesave accounts, were 4.5 billion [euros]. So it was completely impossible to do in fiscal terms. Then, in addition, if you had done that through some magic, it wouldn't have made any sense, because the illiquid assets that needed refinancing were not in Iceland. They were in the UK and the Netherlands and Northern Europe, and it would have amounted to a very significant net transfer of resources at a time when the country was in a huge crisis. So it was impossible to do, and therefore it was the UK and Netherlands authorities that paid the insurance in order to stop the run in their own countries, with the aim to recoup it from Iceland afterward. . . . The foreign currency liabilities of the banks [far exceeded] the central bank's FX liquidity, including the swaplines. . . . It was absolutely impossible to deal with that.

This episode led to the so-called Icesave dispute, because the UK and Netherlands authorities claimed this back from the government, so there was a lot of discussion in Iceland. Is this a sovereign liability issue? Should the government pay this? These were private banks—this was a debt of private banks. Of course, there was this EU directive on deposit insurance, but I tell you, I read it: it is one of the worst-written documents in the history of mankind, because it's impossible to understand. It's supposed to be some guarantee, but it doesn't say who is going to guarantee what, et cetera, et cetera. They have fixed that now, up to a point.

But . . . the conclusion was still the same: to negotiate a settlement. There were three settlement bills passed through Parliament. They were rejected twice in referenda, so at the end of the day it went to the EFTA [European Free Trade Association] court, which then ruled that there was no sovereign liability. Therefore, these authorities are going to recoup it from the estates of the fallen banks. Unfortunately, the estimated recovery is such that it will cover both insured and uninsured deposits fully, and the priority given to deposits in the emerging sphere is key to that. . . .

The crisis hit government finances very hard . . . [in terms of] the direct fiscal costs. . . . In this country, it was a sovereign debt crisis. In our case, it was the banks that collapsed on the government and created a fiscal problem—not a full fiscal crisis, but a fiscal problem. And we arrived there shortly after Ireland, and that had a huge, very direct effect on our debt levels. We had relatively low debt levels going into the crisis, fortunately—I cannot recall right now, but something like 35 percent of GDP gross debt—and a very small net debt. But since then, it has gone up, because of the cost of the crisis and the deficits that were created by the recession, and it's now, in gross terms, something like one times GDP.

Fiscal consolidation was part of the IMF program, but it only started in 2010. Basically, in 2009 we allowed fiscal automatic stabilizers to work, and that mitigated the recession. But at that time, an immediate fiscal plan had already been announced, so the negative confidence effects of the deficit created in 2009 [weren't] that tremendous. Of course, [our effort, as big as it was,] does not compare at all to the effort that [Greece] has made, which is absolutely huge. And what you see there is basically the fiscal effort as measured by cyclically adjusted primary balances—the change in cyclically adjusted primary balances. Greece is up there, with something like 18 percent, and then we have Ireland, and then we have us, with something like almost 8 percent—and in our case, most of that is revenue. Monetary policy was able to support that, because early depreciation had, of course, a very significant short-term effect on inflation, which shot up to 18 percent, and then it came down. That also caused just a part of the adjustment mechanism, because what needed to happen in the country was that real income levels, real wage levels, were far too high, and they were already far too high before the crisis. So what happens is, the exchange rate goes down, inflation goes up, real wages go down, real imports go down, and real exports go up. Once this went out of the system, we were able to bring real policy rates into negative territory, and thus support the recovery. This, then, was very much helped by capital controls.

Korea, after its financial crisis . . . had to take real short-term interest rates up to 6 percent in order to defend the currency. They didn't use capital controls, but they wanted to stabilize the currency using monetary policy. You see no such effect in our case, because the capital controls took care of that, and that created a kind of a shield for us to have lower interest rates than otherwise. That has been very helpful also in terms of financing the government deficit that opened up, which has been . . . exclusively financed domestically, at very low rates. . . . On average over this period we are talking about *negative* real interest rates, and they only went as high as just below 1 percent at the peak in 2010. That is how the capital controls helped us stabilize the economy.

We have rebuilt a domestically oriented banking system, as I said, which is much smaller. When that was done, assets were transferred—domestic assets, basically—from the failing banks to these new banks, at a deep discount, because it was clear in light of the crisis that the value at which they were put in the books of the banks was never going to be realized.

Unfortunately, with the discount, the idea was to err on the downside so that there would be an upside in the running of these banks. And there has been: they are highly profitable. They have high capital ratios, 26 percent liquidity buffers; their leverage ratio—that is to say, debt to equity—is 4.6, whereas, I think the European average is something like 16 at the moment. Their financing is, of course, shielded behind capital controls, and they still need to prove themselves outside capital controls. They had very high nonperforming loan ratios, but these have been coming down. They peaked at 18 and are down to 5.

One more policy, not to forget: we had a very significant program of private sector debt restructuring. Of course, a lot of that was automatic, especially in the corporate sector, just through defaults, write-downs, and the banks cleaning up their balance sheets. . . . Household debt as a share of GDP peaked at 133 percent of GDP just after the crisis. Part of that was, of course, due to the depreciation of the currency and higher inflation. It's now down to one GDP or thereabouts—108 [percent]—so this is something like a quarter of a GDP reduction.

But the reduction is even bigger in the case of the corporates, where we are talking about something like a . . . fall in the debt level [equivalent to 175 percent of GDP]. So the debt level has been reduced in the private sector by [almost] two GDPs. Of course, a lot of that is just through market processes and the banks, but there were also programs instituted by the government [that] I don't have time to go into here.

So these were the policies. Then, what subsequently happened was, of course, a result of the shocks and the adjustment mechanisms within the economy and the policies. What did happen was, of course, we went into a very deep recession. . . . Our total output loss was something like 12 percent from peak to bottom—but then, remember, some of the output level before the crisis was unsustainable. We did even better in terms of the unemployment rate: it peaked at 8 percent but is now coming down into the 4.5–5 percent range. That is not only because of the recovery; that is also due to the flexibility of the labor market due to the external labor mobility we saw in the Nordic countries, mostly, but also because wages are very flexible—and I'm talking about real wages because of the currency.

Then the economy stabilized. It started to stabilize on the nominal side in the middle of 2009. We had a huge current account deficit in 2008, something like 18 percent of GDP, and we turned that into a significant surplus in the course of one year. That's a huge adjustment—and a very painful one, I can tell you—but that is what was done. Then, as a result of that, the exchange rate stabilized without any intervention. There were interventions to support it in the first half of 2009. It stabilized in the second, and then it started to appreciate in 2010, and that meant that the inflation came down faster and we could take interest rates down. Then we had the recovery, starting, as I said, in the second quarter of 2010. According to the latest numbers, which is the second quarter of 2013, we have recouped something like 7.5 percent of the outflows. This year we are predicted to grow 2.3 percent, and then pick up into the 2.5–3 percent range in 2014–15.

Behind both the crisis and the recovery is a very significant readjustment within the economy. . . . [In terms of] the sectoral contribution to the economic contraction, the biggest contribution came from construction, then . . . financial services, so it's basically the financial sector and construction that collapsed. The contraction in wholesale and retail trade was more of a kind of effect of the overall adjustment in demand.

Then we [went] into recovery. It's mostly the traded goods sector that is driving the recovery, [particularly] transportation and tourism. Tourism has grown in a very, very big way, because Iceland is cheaper [than] it used to be. Then you have wholesale and retail trade, fishing, and financial services, [which] are still contributing to a contraction—the adjustment is still going on.

But we are not out of the woods. We face, at this point, one very big challenge. Remember, we instituted . . . comprehensive capital controls on outflows in November 2008. . . . Iceland still has these controls, and that is because we are still in a balance-of-payments crisis. It has three elements. The first element is that the contractual foreign debt repayment in excess of reasonable estimates of the current account surplus is very significant in the next few years. If you take 2013–14 to '18, we're talking about an account of excess debt [equal to] 20 percent of GDP. Remember, this is a country where only the sovereign and the central bank have free access to capital markets. Other sectors still find it very difficult to refinance abroad. It might open up in a big way during this period, but still, this is a problem.

The two other aspects [are] the current overhang in the króna that I mentioned earlier—40 percent of GDP, now [down] to 20—and then the unwinding of old banks, which is still to take place. The estates of the old banks are still domestic entities that are in an unwinding process.

If we just think about this króna [and] credit overhang of 20 percent, if the krónur in the hands of the old banks are to be distributed among creditors—I hope it's not going to happen, and I think we might find other ways to deal with that—but if it were to happen, then that would add something like 26 percent of GDP to the overhang. That creates an overhang of 46 percent. At the end of the Second World War, when the UK came out of the war a much weaker economy, there were all these sterling balances floating around. They were 32 percent of GDP. They couldn't be honored, and therefore the UK introduced capital controls and kept them more or less effectively until the late 1970s. So it took a while. Hopefully, it will not take as long for us, but it is clear that lifting these controls will be challenging.

But I need to say, we do not face a sovereign debt problem. The sovereign has kept market access and has paid everything and on time and in full, and will continue to do so. Iceland does not face a net external debt position that is unsustainable in a traditional sense, so if you can smooth the profile, the surplus and the interest rate differential on the growth rates are sufficient to take debt on a downward trajectory. But we need to smooth [the] foreign debt service profile and we need to have realistic valuations in terms of effects of the [offshore] króna positions . . . because of the failed banks if we are going to be able to make the capital account free again.

Finally, what are the lessons for others here, including the eurozone and its member countries? The first one is, of course, that it's important to reinvent the sovereign in face of private bank failures. That is a lesson [from which] you can draw in a positive sense in the case of Iceland—and I know that my Irish friends forgive me for saying so because they say the same now, in a negative sense, in the case of Ireland. So that was key to what we did. We tried to avoid socialization of private sector losses, and we did that with these concentrations that I mentioned earlier, which was the sovereign on the one hand and the payment system on the other.

The second lesson I want to mention is these flaws in the European Economic Area framework for cross-border banking. The basic flaw is well known to all of us—it was not so well known before the crisis—and it is that the European freedoms for banks were not matched by public action at the European level; that is to say, international supervision, deposit insurance, lender of last resort, and crisis management and resolution. Then, in addition, FX risk was largely ignored. It was assumed that [if] banks based in Iceland or Germany . . . had the same rate of capital leverage ratios and all the rest of it, they had the same risk profile. But that was absolute nonsense. The bank in Frankfurt had access to the ECB, in terms of its liquidity. The bank in Iceland, at least when it was collapsing, only had access to the Central Bank of Iceland. Therefore, there was a huge vulnerability in the setup, especially for small countries outside the euro area.

There is also a lesson here for deposit insurance—basically, that we have that here to stop runs, but it only works if it is in your own currency; if it is a run on asset liabilities, it doesn't work. Therefore, you need some kind of international cooperation on that if it is going to work at all—either a banking union, including deposit insurance, or generalized swap lines, or something like that. And you need to reform the EU framework along these lines. Everybody agrees with that now, but I only want to stress that if you're going to look at the Icelandic experience, a banking union has to include all the elements, including deposit insurance.

In terms of fiscal policy, the lesson is that fiscal consolidation can be consistent with economic recovery, but it is case specific and [varies] from country to country. In our case, we had fiscal consolidation starting big-time in 2010. It didn't derail the recovery. Quite the contrary: it was key to restoring confidence and opening market access.

In terms of the exchange rate, it's good to have a flexible exchange rate. Is it good to have an exchange rate of your own, or is it better to be in a monetary union? The answer is both, in the sense that, in our case, a flexible exchange rate was part of the problem. It did, of course, create the internal imbalance situation, but it was also part of the solution, because it turned around the current account in a big way and it created the foundation for the recovery. . . . [This was visible in] Iceland's total exports: there was very little dip during the crisis, whereas [there was a dip in] the imports of our trading partners. . . . This was, of course, partly due to the exchange rate. So, do you want to get rid of the problem or do you want to have a solution when you have a problem? I don't know.

In terms of capital controls, they were helpful in stabilizing the economy and they are still helpful, it seems, but the cost of those accumulate with time, and we are feeling that now. It is a real impediment for the ongoing connection of Iceland to the rest of the world. But lifting them will be challenging and, in some sense, if you want to draw a general lesson, it is better to deal with the capital inflows if you want to avoid having to deal with the capital outflows.

In terms of small open economies, the lesson is that policy conflicts are very risky. In our case, fiscal policy was too lax and monetary policy was burdening all the adjustments. You should not worry about big government surpluses during booms: they disappear. The current account deficit matters. There are pros and cons of exchange regimes, but they vary from country to country, and as such do not prevent financial crises. Look at some of the eurozone countries in crisis—look at Iceland. There's no panacea here. And—very important—you should always act on the specific risk profile of your own financial sector.

Also, when you're introducing regional and international regulations: if we were to do it over again in Iceland, we would not have adopted the EEA regulations of cross-border banking just wholesale. We would say no, this is too risky for us. We need to have some limits on the size and composition of asset policies of banks. That means macroprudential rules [and] all that stuff. Some call it capital controls. Call it what you may, but you need to act on your risks.

Finally, why was Iceland so successful, then? I think it has to do, first, with the nature of the shocks. The shocks hit initially in the frothy sectors of finance and construction, but the export base and the rest of the fundamentals were still there. It is a flexible economy, especially the labor market, [with a] flexible exchange rate. The private sector debt restructuring helped, but the economic program with the IMF that we concluded some while ago was also very helpful in creating external confidence and also internal discipline. And fiscal prudence, in two senses: good initial positions, so we had low debt levels and therefore we could deal with the fiscal consequences; and then secondly, no socialization of private bank liabilities, and a medium-term fiscal consolidation.

You should not draw the wrong lessons from the Iceland case. It is not safe to let the whole banking system collapse. We did not do that. . . . But you should try to ring fence the infrastructure and have separation in resolution. Fiscal consolidation can be consistent with growth, but timing does matter. And, finally, we need to make financial globalization safer, both as regards cross-border banking and volatile capital flows.

Thank you very much.

Q&A

Q: . . . How did you manage to keep your exports base intact while the financial sector was collapsing and, I suppose, export credit was also collapsing?

MG: That's a very good question. It was a close, close call. Remember that . . . the biggest banks collapsed after the British instituted a freezing order on the whole banking system of Iceland—not only the banking system, but also the sovereign and the central bank for a while—using terrorist legislation. That meant that the external payments system of Iceland completely broke up, because even if we had created new banks, banks around the world were not willing to do FX transactions with these new banks. They said, "These are the old banks in a different disguise—and, by the way, the British have introduced a freezing order on you or used terrorist legislation, so we are not going to deal with you."

[As a result,] we had to take the whole external payments intermediation into the central bank. The central bank in some cases had to guarantee [payment]. There was a ship on the way with oil, and the central bank had to guarantee the payment. We then got help from J. P. Morgan to help us . . . channel the payments that were supposed to go through the banks, and [these] went through the central bank.

It was only after a while, when Iceland exporters—because remember, we export a lot of fish to the UK—called up their importers in the UK and said, "Look, we have sent you a lot of fish, but we haven't received any payments from you." [The importers] got very worried, because it might mean that all the fish and chips in the UK might stop. So they called the local MPs and said, "We want to pay these guys in Iceland, but the government's telling us that we're not allowed to do that." And that is how it then started to break down. But it took a while, and there was a temporary hit to exports. But then the bulk of our exports is fish anyhow, then the aluminum sector, and the aluminum sector [is made up of] international companies that can take care of their own in terms of the financing. But it was a close call.

Q: Governor, I notice you said toward the end, "Don't worry about big fiscal surpluses when you have a boom." But isn't the counterpart to a big fiscal surplus a big private sector deficit, unless you get an increase in your current account surplus during a boom, which tends to be unusual? Isn't this part of the overshoot in the private indebtedness that goes on during the boom, to have the government running a larger and larger fiscal surplus?

MG: You're absolutely right. But you can look at it differently. . . . Usually what happens prior to a financial crisis—I'm not talking about a sovereign debt crisis—is that the private sector overextends. The saving rate becomes too low, and there's a lot of optimism [about] the future, you are borrowing abroad and [have] free access to capital. Therefore, they go into deficit because they say times are good now, but wait, they will be much better after a year or two. And I think it's proper, then, that the government sector, in many senses, kind of leans against that. . . . At least, I was very skeptical of this view. However, my former boss at the BIS [Bank for International Settlements], . . . Bill White, was always saying, "This is going well, and badly," and I thought what was happening in Iceland was going to end badly. It makes sense to prepare for that, because when you have the adjustment the private sector will reverse in a massive way, and then you should lean against that as well. But then you need to have the ability to do that. A country that is very indebted, that does not have foreign exchange reserves and all the rest of it, doesn't have that possibility. Fortunately, we had a low level of sovereign debt. It would have been better to have it even lower at the time. And we should have built foreign exchange reserves in a much bigger way, but we didn't.

So you're absolutely right on this. But I don't think it [takes] away from my conclusion, because in a sense some of what is happening in terms of the surplus is that you think you have a cyclically adjusted surplus, but that is only because you don't know about the crisis that is looming. . . . In retrospect, when you do calculate potential output after 10 years, you know that what you thought was a structural surplus wasn't structural surplus at all; it was only cyclical, and maybe you were in a structural deficit. So I would say, in that kind of a situation, don't worry about big surpluses, especially in small open economies. It will correct. And if you are proven wrong along the line, you can always lower taxes or do something. But in the short term, don't worry about it.

ALEXIS TSIPRAS

Leader of the Opposition (SYRIZA), Hellenic Parliament

Thank you very much. The way things are evolving in Greece, it is, I think, easier to become the president of the European Commission [than leader of the opposition party]. Anyway, I think that these are two interconnected dynamics. Things in Greece cannot change if things in Europe do not change. At the same time, changing correlations in Europe will rely on a major political change in our country, which is about to come.

Ladies and gentlemen, it is a great honor and pleasure for me to address this important conference looking into the causes and consequences of the crisis at such a critical moment, both for Greece and for the whole of Europe. It is a dual honor, because the organizer of this conference is the Levy Institute, a research institute with global prestige that has made a significant contribution to progressive economic and political thought.

Allow me to make a short introduction with some theoretical references. Marx, in his 11th position on Feuerbach, said the point is, we need to change the world, and that's why we are trying to interpret the world. That's what he was saying: we are trying to interpret the world because we want to change it. Interpreting the world is not a purpose in itself. The thing that attributes a higher value to these events organized by the Levy Institute is exactly this orientation . . . toward theoretical pursuits and research activities, because ideas have to be posited and actions need to be taken in order to change things.

Ladies and gentlemen, dear friends, Greece, . . . which has been treated from the very start as the greedy pig of the crisis, needs no more findings and conclusions and confessions and repentance. We need actions, because the country is sinking, the economy is sinking, and society is in despair. We are not discussing theoretical models here. Millions of people suffer, so politicians know economists cannot play with words, and we cannot hide figures behind the words. The destructive austerity program . . . of the memorandums needs to be discontinued immediately. Any continuation of this program is not an error anymore: it is a conscious, criminal choice. It is a conscious choice to aggravate the humanitarian crisis in Greece, with its thousands of victims. It is not just their prosperity and dignity that [are] threatened; their very lives are in danger. This is not a game.

Yet it is not impossible to have the International Monetary Fund admit, on one hand, the error in the recession multiplier or that there have been wrong approaches in terms of the growth of the Greek economy; and, on the other hand, . . . demand the continuation of the program—the continuation of . . . the error, in other words. It's not impossible to have the president of the European Parliament, on one hand, denouncing the setting up of a committee to investigate the choices and actions taken by the troika in

Greece—in other words, to investigate the failure of the program—and the troika, on the other hand, . . . demanding that this program be continued as if nothing had happened.

This hypocrisy needs to be stopped . . . immediately, because—I repeat—we [are dealing] with human lives here. Once we all realize with sincerity the dead end, the impasse, of the choices made in Greece—and, I would add, . . . for the whole European area and for the South of Europe—then we need to allocate responsibilities and then find a way out. I think the contribution of your conference here today is critical to this direction, so allow me to say a couple of words on . . . how we can look for a way out of this crisis, and how we can allocate responsibility.

Let me talk about the exit [from] the crisis. In our country, this very low, humiliating level of political debate is not helpful at all. The communication team of the government likes editing video clips [to support] their distorting views and opinions, which is not helpful at all in starting an essential and constructive dialogue on the key topic. In my view this topic is how Greece can make use of any production capacity it may have to recover from this crisis.

From the other side, there's [been] no serious proposal on this item—apart, of course, from the view that the Memorandum of Understanding is the gospel or, as the minister of finance, [Yannis] Stournaras, said, the most serious document ever drafted in this country. Apart from that, there is no other serious proposal for any exit from the crisis.

And apart from that, even the criticism made is ridiculous. . . . During these last four years, I wonder how many times I have heard the same people being seemingly surprised when they hear a serious or solid view on the problem of the eurozone and the position of Greece in the eurozone.

But this is of minor significance, because [these are] just cheap communication tricks. The substantial issue is that Greece today is [at] an unprecedented impasse. Because of that, the whole of Europe is threatened [by] a destructive domino effect if in Greece and Southern European countries the same program continues being applied, a program that creates more debt and makes us sink even more into recession.

Ladies and gentlemen, when I met [ECB Executive Board member Jörg Asmussen] in Frankfurt a few days ago, I asked him to forget for a while that it was me in front of him—that is, a representative of SYRIZA, which very shortly will be the elected government of Greece. I asked him to forget that and pretend that he had a government in front of him that [would] always obey and observe the Memorandum of Understanding—as if he was speaking, in other words, with [Greek Prime Minister Antonis] Samaras and [Vice President Evangelos] Venizelos. I asked him to wonder what he would do if we supposed there was no SYRIZA at all, and we supposed that there was just the government of Mr. Samaras and Mr. Venizelos. I asked him to imagine how this all could be applied in a destroyed society and with a nonexistent production base. I asked him, "Who are you going to collect more taxes from—from those who have become poor and unemployed due to these policies?" I confess that he avoided a reply, and he changed the topic.

But the main problem is not SYRIZA, and it's not the Greek people who denied the Memorandum of Understanding. It is the Memorandum itself that has failed and pulled the whole country into a crisis [that] now threatens the whole of Europe.

We have drafted an alternative plan. We have a European problem in front of our eyes—it's not something that concerns only Greece—so we have to find a European solution for the problem. We have looked carefully into the matter and we have drafted a sustainable and realistic plan, a real plan B for Greece and Europe. This is our government agenda.

Our government program guarantees both a . . . socially fair exit from the crisis and the productive reconstruction of the country. This is the serious discussion that we need to open in this country. . . . We are talking about a program with three mutually enhanced pillars that form a social plan for the economic-political reconstruction of the country; that is, a plan to be substituted for the bailout program that has destroyed the whole economy and society.

The first pillar of this plan B is stabilization of [the] economy . . . through a socially fair and economically sustainable primary surplus. How can we achieve that? Not by eliminating—by destroying—the whole society and creating social remains and poor people, but by significantly increasing public revenue through the contribution of those who do have wealth, those who are involved in all of Greece's affairs, because there are loads of people who have not contributed at all in these sacrifices made by the vast majority of the Greek population.

How are we going to achieve this? First of all, we are going to proceed with reforming the tax system, so that high wealth and high income can be taxed, and to reduce tax evasion, tax avoidance, transfer pricing, illicit trafficking of goods, fictitious invoices. . . . It is the Transparency Committee that has concluded that because of these last two items, more than 1.5 billion euros are lost from the state treasury each year.

To succeed, it is only political will that is required—the political will to go against the major interests—because it's only a small number of families, actually, a small number of entrepreneurs.

The troika has come to Greece to find a solution. However, while the initial declarations and statements [were] that they wanted to suppress corruption and tax evasion, they actually did exactly the contrary. They worked together with tax evasion and corruption.

Another target that we have is to reform social spending and . . . put under control all those banks which are being recapitalized today with borrowed money; that is, with funds which are then allocated to Greek citizens and Greek families as a burden on their shoulders. We also want to restore the actual purpose of the banks, because the purpose of the banks is not just to . . . grant loans to those they wish—that is, mainly enterprises that support the government policies—[but] to finance liquidity and cash flow in the Greek economy. This is the real purpose, the raison d'être, . . . for the banks.

In order to enhance domestic demand, we intend to stop the free fall of pensions and salaries and the lump-sum benefit that people get when they retire in the private and public sectors. And we want to restore the minimum wage at 751 euros for all workers, regardless of age.

We have been criticized [for] promising anything to anyone. This is wrong. This is the only promise that we have given, and this is not a generous donation or charity. This is a medium for us, a vehicle out of the crisis; because our economic model confirms . . . that even this [small] change in the minimum wage will enhance domestic demand within the first year by 0.75 percent of GDP, and we'll create approximately 7,500 new jobs.

The second pillar of our plan is effective management of the humanitarian crisis and the immediate necessity of binding funds for these objectives, which is of vital importance for Greek society. Toward this end, we have prepared an emergency intervention program, because we want to create a protective shield for the most vulnerable layers of society—the poor, the unemployed, the low-pensioners and low-wage earners.

The third pillar is to reconstruct the production basis of the economy. The goal is to create a new growth model that will highlight . . . the comparative advantages of the Greek economy and ensure . . .

fairly compensated labor, far away from the practices that brought Greece into the crisis. For example, Greece could become one of the main European poles for . . . research on agricultural food items. Or it could become a center for renewable sources of energy and new environmental technology centers. We could do that, and we *have* to do that. We have to refocus our policy on tourism on alternative forms oriented toward high quality and low environmental impact, so that Greece can have more benefits, more privileges, in GDP; because we are a country with major potential in the field of tourism.

Greece has the manpower and can acquire a new position in the global and European allocation of labor instead of being a peripheral economy, a labor-intensive and low-income economy, which was caused by the neoliberal bailout programs. It could utilize its resources effectively and create a new productive potential of young people, of highly educated people with major skills and talents and competencies who have been educated in Greece's state universities. . . . This is a growth advantage that we have—young people, young scientists—whose potential, unfortunately, is being lost because young scientists are obliged to either leave the country or remain unemployed and survive on the low pensions of their parents.

So Greece does have the resources and the ability to break this vicious circle of high unemployment, recession, and growth with low compensation. But also, Greece has the political medium to do that, which is democracy and the political change that sooner or later will come in the country. So the political medium would be political salvation, a government that will break this vicious circle.

Allow me to say a couple of words about this second pillar that I mentioned before; that is, allocation of responsibilities. I [talked] before about the investigation committee [that] was set up by the Parliament to investigate the failed policy followed by the troika in Greece. It is an oxymoron, you know. They speak of a "success story," on one hand; then, on the other hand, they are setting up an investigation committee. . . . How can we justify the setting up of this investigation committee? Well, the political forces which support this history in Greece should make it clear: in the future they either need to criticize the European Parliament the same as they criticize SYRIZA and say that they will not cooperate in this investigation committee because it is offensive, or they need to work together, to cooperate and stop cheating and deceiving the Greek people.

Greece is now [at] a critical juncture, before the political change. We are in a critical moment, where each person assumes [his] responsibilities before the country and the citizens. This is the meaning of the motion of nonconfidence [that] was tabled at the Parliament yesterday by the SYRIZA parliamentary group. It was not only a motion of nonconfidence for all that [has] happened during these last five months—for example, the arbitrary shouting down of the state broadcaster. It [also] has to do with constitutional legitimacy. It is [a vote of] nonconfidence [in] a government that failed to handle the people's mandate for renegotiation. And now, the [longer] they remain in power, the more dangerous they become. They become [more] dangerous because they are trying to turn their failure into harsh punishment of the Greek population.

Ladies and gentlemen, when a country is moving along the edge, there cannot be excuses and pretexts. Note: this motion for nonconfidence would at the same time be a "yes" to a government policy that, because of its failure, is now threatening us with . . . a broadening of the drama. They threaten with the new property tax; [with] the "liberation" of dismissals in a country where official unemployment is 30 percent and youth unemployment is 60 percent. So those who are turning a blind eye and think that if they say no to this motion they [will] rescue Greece or. . . prevent SYRIZA from taking power, well, I think it is an illusion and you are just extending this impasse, to the detriment of the Greek people.

As far as we are concerned, it is an obligation—a duty—to send this government away. It is not the duty of the opposition party; it is a duty for democracy and its institutions.

Some people claim that this has never happened before—throwing down a government following a motion of nonconfidence has never happened before. This is a half-truth. The other half is that history has shown that, in critical moments, such motions of nonconfidence have always accelerated the disintegration and fall of governments, especially those that had just [been] confirmed to the Parliament and it was not long before they lost their confidence within the same Parliament. Let me remind you [that] Mr. Papandreous's government, a while before . . . the Papademos interim government took over, had just received a vote of confidence in the Parliament by almost all the government deputies.

I don't know what the result will be on Sunday evening, but I know that the Greek people [are] asking for this tragedy to end. This can only happen through democracy and through a deep and major political change.

Thank you very much for your attention.

YVES MERSCH

Member, Executive Board and General Council, European Central Bank

Intergenerational Justice in Times of Sovereign Debt Crises

Ladies and gentlemen, the last time I gave a speech here in Athens was in early January 2008. How much the world has changed since then. Yet it has not always changed in the ways that observers predicted. I still remember clearly, in the early weeks of May 2010, the prophetic claims that Greece would leave the euro area within weeks, other countries would follow within months, and the collapse of the euro would be complete before the year was out. Those claims were wrong—and the Greek people have played an important part in proving them so.

Since the loss of market access in early 2010, the Greek people have made extraordinary efforts to refute the naysayers and turn the economy around. They have executed a fiscal adjustment of historic proportions and embarked on the difficult road of structural reforms. The results of these actions have accrued first and foremost to Greece—but they have also accrued to the wider euro area.

However, this turnaround is still only half complete. There is still much work to do. And what I would like to emphasize in my remarks today is that staying on the path of reform is essential not only for the citizens of today. It is also essential for those of tomorrow.

Like all Western societies, and some rapidly aging Eastern ones, Greece faces long-term fiscal challenges linked to high public debt levels and demographic developments. These challenges raise profound questions about intergenerational justice. And it is only through reforms that they can be answered in a fair way.

For all aging societies, this implies, first, ensuring sustainable public finances; and, second, achieving stronger economic growth. Both are necessary because they are mutually reinforcing: fiscal sustainability creates the stability and confidence necessary for future growth, and higher growth creates the revenues and debt-to-GDP ratios necessary for fiscal sustainability.

Let me therefore deal with each in turn, starting with what is being done to ensure fiscal sustainability in the context of intergenerational justice.

Strengthening sustainability

The fiscal challenges that Greece is facing today, while more severe than others, are not unique to this country. All Western societies are being confronted with difficult questions about the distribution of consolidation and spending between current and future generations.

A first question is how the burden of high public debt levels in Western societies will be shared between generations. This question is particularly pertinent in the euro area because all countries are bound by law to start reducing their debts to below 60 percent of GDP—and average public debt levels in the euro area are currently in excess of 95 percent of GDP.

If fiscal consolidation starts today, then the generation [that] has benefited most from this debt will play the largest role in reducing it. But if consolidation is delayed, then future generations will have to bear the burden of debt reduction—this would constitute a direct transfer from our children and grandchildren to ourselves.

And it is only [we] who are taking the decision. Our children and grandchildren have no power to raise their objections.

A second question with intergenerational consequences is how to spread the costs of demographic change. In the EU, it is projected that by 2060 there will be just two working-age people for every person over 65, compared with a ratio of 4:1 today. This means the weight of supporting an aging population will rest on ever fewer shoulders.

If current generations are proactive in reforming pension systems, they can reduce the load that the shrinking working-age population will have to carry. But if they choose instead to preserve their entitlements, then they make the lives of future generations commensurately harder. They would be effectively sacrificing their descendants' quality of life for their own.

In other words, all Western societies are facing choices about the distribution of responsibility. Do we, the current generation, take responsibility for the long-term fiscal challenges that we have played a large part in creating? Or do we delay and pass the consequences of our choices on to our children and grandchildren? I think it is fairly clear what a perspective of intergenerational justice would imply.

This perspective is, of course, not new. The so-called "demographic time bomb" has been predictable for many years. Indeed, I pointed to this issue when I spoke here in Greece in early 2008. But what has changed today is the urgency for action. The crisis has meant that these difficult choices can no longer be delayed. One might say it has pressed the fast-forward button and brought the challenges of the future into the present.

This is the broader context for the ongoing consolidation process in Greece. Certainly, it is about increasing spending control and tax collection. But it is also about putting Greece on a sustainable path for the future; limiting the load that is bequeathed to our descendants, and ensuring that those that created fiscal problems take responsibility for them.

What Greece has achieved

And indeed, this is what is happening in Greece today. The commitment the Greek people have shown to fiscal consolidation has been remarkable, even in international comparison.

The primary deficit has declined by almost 10 percentage points of GDP between 2009 and 2012. Taking into account the deep and prolonged recession, the underlying fiscal adjustment has been even larger. The OECD estimates that structural adjustment was nearly 14 percentage points of GDP in this period.

As Greece is one of the smaller euro-area member-states, the scale of its efforts is not always appreciated appropriately. If the level of expenditure consolidation we have seen in Greece were applied in Germany, it would be equivalent to a permanent reduction in public spending of 174 billion euros. That is more than the total sum of social spending.

Greece has also made important progress in addressing the long-term fiscal challenges linked to its aging population. There is little doubt that before the crisis the Greek pension system was unsustainable.

In the Commission's *2009 Ageing Report*, age-related spending in Greece was projected to increase from 22 percent of GDP in 2007 to a staggering 38 percent of GDP in 2060. By contrast, the average for the euro area would be under 30 percent of GDP in 2060.

But thanks to the pension reforms the authorities have introduced, the Greek system is now comparable to others. In the *2012 Ageing Report*, age-related spending in Greece was projected to increase to just under 30 percent of GDP in 2060—so around 8 percentage points lower than the previous estimate. This is almost identical to the euro-area average. If we take into account as well the recently legislated increase in the pension age, Greece may even be ahead of others.

In short, the Greek people have taken vital measures to ensure long-term fiscal sustainability. This will reduce the burden that will be passed to future generations. And I recognize that in doing so, current generations have made considerable sacrifices. Real earnings have fallen by over 20 percent between 2009 and 2012, undoing the gains made since adopting the euro. Far too many people are currently without work, with unemployment at over 27 percent and youth unemployment reaching 57 percent. For so much potential to be lying idle is a tragedy.

What remains to be done

Nevertheless, this is the painful cost of reversing the misguided economic policies and lack of reforms in the past. And fiscal sustainability—and hence intergenerational justice—is not yet assured. While the government appears to be on track to meet its 2013 primary balance target, Greece still has some way to go to reach the primary surplus targets of 1.5 percent of GDP in 2014, 3 percent of GDP in 2015, and 4.5 percent of GDP in 2016. This means that fiscal consolidation has to continue.

Based on current projections, a fiscal gap has emerged for 2014. It comes mainly from delayed gains from the tax administration reform, shortfalls in the collection of social security contributions, and the continuing underperformance of the installment schemes for outstanding tax obligations. Measures will have to be identified to close it.

Looking forward, failure by the authorities to proceed with tax administration reform and to accelerate the fight against tax evasion will unavoidably widen the fiscal gap—and imply the need for higher savings on the expenditure side. This simple truth should provide sufficient incentives for stepping up the pace of tax administration reform.

To put tax collection in Greece in context, according to the most recent OECD data, the tax debt in Greece as a share of annual net tax revenue was almost 90 percent in 2010, compared with an OECD average of under 14 percent. Fighting tax evasion now is therefore key to enhancing social fairness—both on an intragenerational and an intergenerational basis.

To this effect, the recently legislated semiautonomous tax agency will need to become fully operational and be shielded from political interference.

Beyond that, accelerating the implementation of public administration reform is key to the success of the wider reform agenda. Significant delays have occurred in finalizing staffing plans and transferring employees to the new mobility scheme, and this is slowing down the identification of redundant positions and the necessary modernization of the public sector.

Of course, consolidation would be made easier by higher rates of growth. But we should not treat growth as an exogenous variable. On the contrary, it depends critically on the decisions of the Greek authorities—namely, on their willingness to implement the growth-enhancing measures in the program.

The relatively closed and rigid nature of the Greek economy is both a challenge and an opportunity: it makes the process of reform harder, but it also means that the potential for reforms to raise growth is commensurately greater.

Let me therefore turn to the subject of growth, which forms the second part of my remarks today.

Strengthening growth

The economic situation in Greece has started to pick up this year, with the economy stabilizing and seasonally adjusted real GDP increasing by 0.2 percent quarter-on-quarter in 2013Q2. Overall, GDP growth is expected to turn positive next year at 0.6 percent.

But while these are welcome developments, they still represent a relatively weak recovery, especially given the depth of the recession that preceded it. In my view, to add momentum to this recovery and lay the foundations for medium-term growth, the authorities need to address three challenges: first, increasing the economy's external competitiveness; second, ensuring the banking sector can fund the recovery; and third, attracting productive foreign investment.

Increasing external competitiveness

As Greece is undergoing a simultaneous deleveraging in its public and private sectors, sectoral accounting tells us that its external sector must go into surplus. The key for growth is to ensure that this happens as much as possible through higher exports rather than import compression. The best way Greece can achieve this is by improving its price competitiveness.

Price competitiveness is particularly important for Greek firms as their exports are largely concentrated in low-tech products. At the end of the last decade, high-tech or intermediate-tech products represented only 28 percent of total exports, compared to nearly 50 percent for the EU average. Yet since euro entry, price competitiveness in Greece has actually been on a worsening trend. According to the Commission, the real effective exchange rate (on an HICP [Harmonised Index of Consumer Prices] basis) in Greece was still rising until 2011.

To facilitate an export-led recovery, this trend has to be corrected, and there is no way this can be achieved in the short run other than by adjusting prices and costs. I know the difficulties that such adjustment creates and the criticisms that are leveled against it. But we are in a monetary union and this is how adjustment works. Sharing a currency brings considerable microeconomic benefits but it requires that relative prices can adjust to offset shocks.

This process has already begun in Greece today. Thorough labor market reforms have reduced labor costs significantly. Costs have now fallen by around by 18 percent since 2009, with wage adjustment being the main driver of that fall. Indeed, compensation per employee has fallen by about 20 percent in this period.

But the translation of cost competitiveness gains into prices has been too slow—notwithstanding the encouraging recent trend of disinflation. This is largely because reforms in product markets have not kept pace with those in labor markets. And this not only limits the potential for the external sector to generate growth, but also lowers citizens' real incomes.

Speeding up the pace of product market reforms is therefore a priority. The authorities have introduced several recent reforms; for example, removing barriers to entry in transportation services, repealing restrictions in the retail sector, and removing mandatory recourse to services for a number of regulated professions. However, as of today, product market regulations are still among the most restrictive in

Europe. Further reform will help remove unjustified privileges and the related excess profits, and by helping prices adjust, this will in turn strengthen social fairness.

Funding the recovery

While product market reforms are an essential part of building a more competitive economy, their ability to generate growth depends also on other developments—in particular, the condition of the banking sector.

If banks do not make new loans, this impedes the entry of new players into liberalized sectors, which then reduces competitive pressures and price adjustments. And if banks do not write off loans to insolvent debtors, in particular "zombie" companies, this slows down the necessary reallocation of resources toward exports and higher-productivity sectors.

In other words, cleaning up bank balance sheets and ensuring a well-functioning bank-lending channel is an equally important part of the adjustment process. This is the second challenge for growth.

The authorities in Greece have taken important steps to preserve the stability of the banking sector. The recapitalization of the four core banks was completed in June 2013, while the consolidation of the banking sector has continued through the resolution of nonviable banks and the absorption of Greek subsidiaries of foreign banks. Deposit inflows have continued, in part offsetting the deposits lost between the end of 2009 and the middle of 2012.

But despite these improvements, credit growth to the private sector remains very weak, in particular for the small- and medium-sized enterprises (SMEs) that make up about 60 percent of business turnover in Greece. The last ECB survey on SME financing showed that 31 percent of SMEs had applications for bank loans rejected, well above the euro area average of 11 percent. Moreover, the sectoral allocation of credits has not substantially shifted toward export-oriented sectors since 2010, suggesting that banks are not facilitating internal rebalancing.

To some extent, these developments are cyclical: the weak economic environment means banks are attaching higher credit risk to SMEs. But there is also a more structural explanation. Nonperforming loans (NPLs) increased from 16 percent at the end of 2011 to 29 percent of total loans in the first quarter of 2013. This is acting as a barrier to new lending to higher-growth sectors.

Unfortunately, this problem is in part being created by government policy. The ongoing moratorium on auctioning the properties of debtors in default has slowed down resolution of NPLs and balance sheet restructuring. Moreover, suggestions by policymakers about horizontal debt relief for bank debtors are leading to a steep rise in strategic defaults, with banks estimating that 25 percent of NPLs in the mortgage and SME sectors are now strategic.

This deterioration in the payment culture, even if it helps individuals on a micro level, is deeply damaging to the economy as a whole. If it continues, it will ultimately lead to higher costs for banks, new recapitalization needs, and further constrictions in bank lending. In my view, to restart lending to the real economy, this self-fulfilling cycle must be broken.

I welcome the fact that the Greek authorities have established an interagency working group to identify ways to improve the effectiveness of debt resolution processes. Its priority should be to establish a time-bound framework to facilitate the settlement of borrower arrears using standardized protocols. This would help to remove expectations about future debt relief, and as such, remove the debilitating moral hazard this is creating.

Otherwise, the ultimate result would be that excessively high-risk premia become structural and choke off investment and job creation—thus punishing the whole of society for the actions of those in strategic default.

Attracting productive foreign investment

The third challenge for growth is to attract higher foreign investment. This is important to add momentum to the recovery in the short term, while also increasing the capital and knowledge base of the Greek economy over the medium term. Indeed, before the crisis, investment in knowledge-based capital in Greece was among the lowest in the euro area.

From the available signals, there seems to be significant investor interest in Greece. While total investment in Greece has fallen by around 43 percent from 2008–12, foreign direct investment (FDI) flows have recently been positive, driven largely by investment in the banking sector. But anecdotal evidence suggests that foreign interest in the real economy is also growing, with several multinational companies announcing plans to increase their output at Greek units in the coming years. To maximize such investments, I see three actions as key.

First, the authorities need to redouble their efforts to improve the business environment. Product and labor market flexibility is certainly a part of this, but there is also a wider challenge related to reducing bureaucracy, red tape, and corruption. Progress has been made in these areas but Greece still ranks second to last among euro area countries on the World Bank's Ease of Doing Business Index.

Second, foreign investment would naturally rise if privatization were increased. In 2012, only 0.1 billion euros [were] derived from privatization receipts, instead of the 3.6 billion euros originally forecast. Yet the example of the Port of Piraeus shows what well-targeted privatization can achieve. Since the transfer of management of part of the port to the company COSCO in 2009, container traffic has tripled and its market share in the Mediterranean has risen from 2 percent to 6 percent.

Third, it is crucial for foreign investors that uncertainty about Greece's medium-term outlook is dispelled. The greatest source of such uncertainty in the past was persistent questions about Greece's place in the euro area, but thanks to the joint efforts at the European and national levels, this seems to have significantly declined over the last year. The main source of uncertainty today is the continued commitment of the authorities to the program. I therefore trust that the authorities will do everything possible to remove such doubts.

Conclusion

Let me conclude.

Greece has made tremendous progress in recent years to close its fiscal deficit. By any standards, what has been achieved is remarkable.

But the process of restoring sustainability and growth in Greece is not yet complete—and neither is the progress so far secured. If the authorities fail to address the remaining challenges, they will put at risk what has already been achieved.

In other words, Greece today stands at a crossroads.

In the one direction lies the path of difficult choices. This is the steep and thorny way, and it requires great commitment to negotiate, but it is the one that will lead to a reformed state, a sustainable economy, and justice between generations.

In the other direction lies the path of easy answers. This path is littered with false alternatives, such as recurrent proposals for debt restructuring.

To some, debt restructuring or larger haircuts on government bonds may seem politically attractive. But such practices can only be a last resort. They are by no means a sustainable option to ease a government's financial obligations. They would not help to promote fiscal discipline and could create higher costs in the long run. And they would do nothing to address the fundamental weaknesses in the Greek economy.

In short, the path of easy answers leads to stagnation, decline, and an overburdening of the young and future generations.

From what I see today, I trust that the Greek people know which path they need to take. A recent poll shows that 69 percent of the public supports the euro—and being part of the euro means taking tough but necessary decisions.

Responsible choices and reliability are the preconditions for solidarity. Greece has already received support from other euro-area countries equivalent to 17,000 euros per Greek citizen. And, provided that it complies with the program, those countries are committed to supporting Greece until it regains market access.

In short, all the conditions are present for Greece to return to prosperity—and for the sake of both current and future generations, I trust that Greece will make the most of them.

Q&A

Q: . . . Just a quick question: So the European Central Bank moved down the interest rates just yesterday. I wanted to get a feel from you on how this could impact the whole process of reform and recovery that you just described. . . .

Moderator: Let's take another question and then go to the speaker.

Q: Jörg Bibow, Levy Institute and Skidmore College.

If I understood you correctly, you said that falling wages and prices in Greece are welcome. We know that a deflationary environment does not tend to be good for the health of banks; so how can you both welcome more deflation and, on the other hand, emphasize that healthy banks would be important for Greece's recovery.

Also, given that the ECB is currently undershooting its 2 percent mark very significantly, one may wonder why the ECB tolerates deflation to this extent in Greece and perhaps even asks for more, instead of hoping for a faster rate of inflation in some other member countries—for instance, those with large current account surpluses like Germany. . . .

YM: I think both questions, to some extent, are related.

First of all, when I say that lower wages and prices are welcome, I make the distinction between so-called "good deflation" and "bad deflation." If I see that a country inside the Monetary Union cannot devaluate, then it has to proceed by another way to the adjustment of relative prices. And instead of an external adjustment, you have to proceed to an internal adjustment of relative prices. This is the development that has taken place.

But since we speak about comparative prices, about relative price adjustment, it also is clear that if other countries do the same at the same moment, it will be more difficult for the first country to achieve its adjustment process in a shorter period of time. From that point of view, since there needs to be a difference in the price developments in the country that is adjusting compared to the other countries, it is certainly true that we deliver on our mandate of keeping our price developments of close to, but below, 2 percent over the medium term. And I think this we can consider as price stability, which means that we are not interested [in] or not willing to deviate from our mandate to create artificial inflation just to allow an artificial price adjustment of lower quality, because we do not believe an inflationary environment [to be] socially fair.

But it is certainly true that the decision that we took yesterday is related to the medium-term developments of price developments in the price pressures in the euro area that we have been able to observe over the last couple of months. And it is not related only to one-time negative surprise, which was particularly evident in the October price developments; but those price developments, to a large extent, were due to energy and food prices, which are beyond the level of control of monetary policy. . . . Next month, we will publish our readjusted forecast for medium-term price developments, which might well be showing why we immediately reacted and did not wait until this evidence would have to be published.

But again, we have seen in the past Greece having consistently higher wage and price developments compared to its other competitors in the euro area, and that is exactly the reason why now, in order to rebalance, it has to adjust by having, over a certain period of time, lower prices and wage developments. And Greece has done that, because it has made the choice, and the people of Greece have made the choice, to stay within the euro area, much to the displeasure of those who had predicted the implosion of the euro area.

LORD ROBERT SKIDELSKY

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The Experience of Austerity: The UK

Ladies and gentlemen, I'm very, very pleased to be giving this talk on the UK experience of austerity. And, as that indicates, I'll be talking mainly about British experience.

Britain was not Greece, though the arguments for austerity were roughly the same in both countries. And listening to the earlier panels, I realize . . . that in Greece there is much less discussion about monetary policy, because Greece, of course, doesn't have its own central bank. Also, I perhaps don't talk enough on the British context of exchange rate policy because, although we do have our own currency and it has depreciated by 20 percent or so against a weighted basket, its effect on aggregate demand has nevertheless been quite small.

We start, as many others have done, with the good news about the UK economy. Britain is recovering, and . . . there has been a bit of growth. But there was growth also in 2009–10, . . . and then look what happened in the intervening three years. We can go through some of the statistics, but I don't think it's that important. I think the estimate now is that the UK will grow by just under 2 percent in 2014, and that's slower than the rate of growth predicted for the United States but more than the growth predicted for Germany, at 1.4 percent; Japan, 1.2 percent; France, 1 percent; Italy, 0.7; and Greece, 0.7. These estimates have tended to be wrong. They've either been too pessimistic or too optimistic. So the forecasters don't really know what's happening at all, but so far, so good.

The Chancellor of the Exchequer [George Osborne], though, will be able to say that he has pulled it off. He will claim a number of things for his policy that are either false or implausible. First, he'll feel entitled to say that his critics, people like me, have lost the battle because they can't explain why the economy is improving. "Like it or not," he says, "the growth figures show that austerity is working." That's a direct quote.

However, I haven't yet met a single critic of George Osborne's policies who claimed the economy would *not* recover from the collapse of 2008–09. Sooner or later, economies always recover, whatever the policies pursued—that is, recovered from their low points, because things happen in the country or in the world [that] revive animal spirits. It may be the opportunity afforded by the fracking of shale gas, as in the United States; it may be a new generation of computers, or high-speed trains, or something. Capital equipment also wears out, so there's always going to be some recovery. The question is whether it's going to be an L[-shaped] recovery, as a previous speaker said, or whether it's going to be a really good recovery. The key issues are whether the recovery was delayed by austerity and whether it would be stronger without continued austerity.

I agree with Martin Wolf, the *Financial Times* columnist, when he says that "austerity cannot kill the economy, but it can inflict a great deal of unnecessary suffering and waste." So the pickup in activity, while welcome, does not settle the debate about how the economy might have fared under an alternative strategy and how it will fare with the current strategy.

What defense of austerity can George Osborne offer? First, he might argue, and indeed he did argue, that the United Kingdom had no choice but to resort to austerity. The government had too much debt, and therefore it couldn't afford a stimulus. As Osborne and [David] Cameron claim, "The government can't spend money it hasn't got." I thought quite recently of compiling a book of economic fallacies [that] have been uttered by political leaders during the course of this crisis. That would be one of the leading examples: "The government can't spend money it hasn't got." The claim was—Angela Merkel has said this many times—government had been overspending, and like a household in a similar position had no alternative but to tighten its belt.

Now, that's simple stuff, but, in January 2010 two economists, [Kenneth] Rogoff and [Carmen] Reinhart, produced a much-quoted paper, "Growth in a Time of Debt," which gave credence to these banalities uttered by politicians. It claimed that growth falls if the government debt-to-GDP ratio rises above 90 percent—you know, if you take the average, it falls catastrophically by 4 percent. They all looked at charts like that, and those charts, those claims, were welcome ammunition for the fiscal hawks. At that juncture, recalls John Cassidy, governments on both side of the Atlantic were pursuing Keynesian stimulus programs but were debating whether or not expansionary policy should be wound down to balance the budget. At this point in the debate, Rogoff's message in favor of austerity gave the fiscal hawks a powerful shot in the arm.

In February 2010, Osborne, soon to be British Chancellor of the Exchequer, said . . . , "As Ken Rogoff himself puts it, 'There's no question'"—*no question*—"'the most significant vulnerability as we emerge from the recession is the soaring government debt. It's very likely that will trigger the next crisis, as governments have been stretched so wide. The latest research suggests that once debt reaches more than about 90 percent of GDP the risks of a large negative impact on long-term growth become highly significant." Says George Osborne, "If off-balance-sheet liabilities such as public sector pensions are included we are already way beyond that. And even on official measures of debt, we are forecast to break through 90 percent in the next two years. And so our aim will be to eliminate the bulk of the [structural] current budget deficit over a Parliament"—that is, over five years. Rogoff basked in his glory. He was everywhere. Everyone was listening to him. Invitations, fees, the whole lot followed.

[However,] gradually, his findings were increasingly challenged, and increasingly effectively challenged. For one thing, [he and Reinhart] failed to explain clearly the transmission mechanism between high debt and lower growth. In fact, they failed to explain it at all. It was just a statistical correlation. The implicit theory seems to have been that excessive state spending crowds out more productive private spending. But, of course, this applies just as much to tax finance spending as to debt finance spending. Debt is, after all, . . . a form of taxation.

So why is the debt-to-GDP ratio the crucial number? Perhaps what the authors had in mind was that a rising debt level undermines people's willingness to lend money to the government. As the debt-to-GDP ratio rises to historically high levels, the markets start to fear a default, and the government has to pay more and more for its borrowing. This drives up the term structure of interest rates and thus stifles growth.

I mean, it may be that a theory like that was at the heart of it, but this scenario assumes a fixed money supply. A country with a central bank which can issue its own currency is clearly in a different position to a country like Greece, which is entirely reliant on the sentiment of bondholders, and particularly foreign bondholders. The UK was one of the few countries that actually did have a choice between austerity and stimulus. With a central bank [that] could print money for the treasury, there's no reason for the cost of government debt to go on rising and rising and rising.

Of course, I wouldn't deny that there are limits to the inflationary financing of a deficit. At some point of hyperinflation people will stop using the currency. But it's absurd to think that Britain was anywhere near this situation in 2010. And insofar as expansionary fiscal policy increases national income, the debt-to-GDP ratio will fall automatically, lowering the cost of new bond issues. Osborne's argument, that fiscal austerity was needed to keep down the cost of debt, was wrong theoretically and has proved wildly wrong empirically.

Another argument frequently heard—this is also a feature in my list of favorite fallacies—was that debt reduction was required to ease the burden on future generations. ECB Executive Board member Yves Mersch repeated exactly this argument yesterday—not once, but about five times in the course of his remarks. The argument seems to be that if the present generation spends more than it earns, the next generation will be forced to earn more than it spends in order to pay for the profligacy of this generation. The argument is completely fallacious, and it's fallacious because among the future generations are holders of the debt.

Suppose my children have to pay off my debt. They will be impoverished by doing so but the owners of the debt will be enriched. This may have undesirable distributional consequences, but the present generation leaves no net burden to its heirs. And that, in the theoretical argument, is complicated when a country's national debt is owned by foreigners. I said that in the *practical* argument it's complicated when a country's national debt is owned by foreigners; that's the case with Greece, but not with Britain. But the theory is where you start this argument from: no net burden for future generations. So let's leave the debt question.

Second, Osborne might argue, and in fact did argue, that fiscal austerity can be expansionary. We've had a bit of discussion of this in previous panels. This was the theory of expansionary fiscal contraction, which was much in vogue in 2010. The argument for this was explained by [Martin] Hellwig and [Manfred] Neumann in a 1987 paper. I'll just read out the first bit . . . : "According to conventional wisdom, any policy of consolidation is [likely] to contract real aggregate demand in the shorter run. This Keynesian conclusion, however, is misleading as it neglects the role of expectations. A more adequate analysis differentiates between the direct demand effect of cutting the growth of government expenditure and the indirect effect on an induced change in expectations. The direct demand impact of slower public expenditure growth is clearly negative. The indirect effect on aggregate demand of the initial reduction in expenditure growth occurs through an improvement in expectations if the measures taken are understood to be part of a *credible* medium-run program of consolidation, designed to permanently reduce the share of government in GDP . . . [and thus] taxation in the future."[1]

That's the argument. That was the form—the more reputable form—in which the argument was put. Notice that it's not being claimed by these authors that fiscal austerity results in a net expansion in aggregate demand, simply that it need not lead to a contraction. But this qualification was ignored by the more enthusiastic fiscal hawks.

A massive econometric research effort went into proving the claim that fiscal consolidation had been shortly followed by economic growth. The researchers certainly established some striking correlations in a small number of cases. In April 2010, the leader of this school, Alberto Alesina, assured European finance ministers "that many even sharp reductions of budget deficits have been accompanied and immediately followed by sustained growth rather than recessions, even in the very short run"—"immediately" and "in the very short run."

But his proofs were vitiated by two fallacies. [First,] the cuts have to be "credible" (that was his qualification)—i.e., large and decisive—so that failure of the growth to appear could be blamed on the insufficiency of the cuts. The reason Greece has not been enjoying the full benefits of fiscal consolidation is that it hasn't been enough. By such twisted logic can recalcitrant facts be made to fit nonsense theory?

Second, the researchers committed the arch statistical fallacy of confusing a correlation with the cause, exactly as Reinhart and Rogoff had done. If you find a correlation between deficit reduction and growth, this could be due either to the reduction causing the growth, or the growth causing the reduction, or both reduction and growth being due to something else—for example, a devaluation.

An IMF paper in 2012 brought Alesina's hour of glory to an end. Going through exactly the same material as Alesina had, the authors pointed out that, while it is plausible to conjecture that confidence effects have been at play in our sample of consolidations, during downturns they do not seem to have ever been strong enough to make consolidation expansionary—a very, very carefully qualified summation of the experience.

So we can ask two questions: what were the effects of fiscal consolidation on the size of the UK government's fiscal position? And, what were their effects on the economy? Obviously, the two are related. Osborne's plan was to set the deficit on . . . an annually declining path from 10 percent of GDP to zero in five years. So here's a bit of outcome. . . . Let's take the deficit first. You start with about 10 percent. He wants it to go to zero two years from now. Well, it's not going there. Even the reduction to 7.1 percent has only been achieved with the help of some dodgy accounting. Fiscal hawks, of course, complained [that] the reason for this relatively poor record was that only part of the planned spending contraction had actually been implemented. Naturally, they would.

Then look at the deficit—the debt—of which he said 90 percent was the end of the world. And there it is. It was obvious to Keynesians that fiscal consolidation would not have its promised effects on the government's budgetary position, because it could not produce that immediate growth promised by people like Alesina. Keynes summed up his own view with the remark, "Look after unemployment, and the budget will look after itself."

Of course, his argument was that any policy which improves national income will automatically shrink the deficit by increasing government revenues and reducing its spending on the unemployed. Conversely, any policy [that] fails to look after unemployment is likely to make the budget problem intractable. And this is basically what's happened. There was a bit of a bounce back in 2009–10. Then the policy of fiscal consolidation was increased. Immediately, there was contraction: three quarters of recession. Now it . . . has started to grow, and is projected to grow 0.68 percent in 2013, as against previous projections which suggested that . . . the economy would be growing by 3.6 percent by last year.

The failure of the economy to grow according to plan had knock-on effects, both on the size of the deficit and on the size of the national debt. There was a similar slowdown occurring in the eurozone—with the onset of austerity in 2010 you have a similar kind of thing. So you have a recovery, and then you go back to, not as far back as in 2009, but there's no real sign of growth in the eurozone as a whole. And the contrast is with the United States, where the fiscal stimulus was sustained and the US economy is now larger than before. So you get the divergence.

Of course, in the end you can get your fiscal deficit down. If the reduction in your national income keeps pace with the cuts in your spending, you can eventually balance your budget at zero with a national income of zero. I mean, of course you can do it in the end. But no one suggests that that is the way. What these projections of success in deficit reduction all assumed was that the reduction would cause the economy to grow, and the growth of the economy would do most of the heavy lifting. Well, the point is, what they ignored was that the fiscal consolidation was actually causing the economy to shrink and not to grow.

Economists Alan Taylor and Oscar Jordà have estimated that each year of Osborne knocked 1 percent off the growth of the British economy, meaning that UK GDP would be 3 percent higher today without austerity. . . . So you're really talking about a very substantial total, 92 billion [pounds] all told—enough to restore the cancelled school building plans and still have enough change to plug the funding gaps in the National Health Service and other projects. To the average household, this amounts to a loss of about $5,000 over three years.

In fact, the outcome has been even worse than that, for it's not just the loss of output [that] needs to be taken into account but the loss of capacity to produce output. In a *Financial Times* article earlier this year, Marcus Miller and I, citing the work by Brad DeLong and Larry Summers, explain how hysteresis—prolonged unemployment or underemployment—destroys not just current but also potential output. If an output gap is allowed to persist for too long, it disappears. The effect on skills, on infrastructure, is so savage that there's no output gap any longer. The lower . . . output of the economy reflects its reduced capacity to produce output, and something like that seems to be happening.

We now move on to the second part of my talk: enter quantitative easing. Rogoff and Alesina have had their day. They're not invited to conferences nearly as frequently as they have been in the past, although perhaps Eugene Fama will be invited to even more now that he's won a Nobel Prize. From late 2011, expansionary monetary policy—quantitative easing [QE]—started to be used to offset the effect of fiscal contraction.

Now, there have been two bouts of this. In the first, between March 2009 and January 2010, the Bank of England injected about 200 billion [pounds] into the financial system. Most people agreed that that injection, coupled with other similar injections all around the world and some fiscal stimulus at the same time, actually stopped the slide into a very, very deep recession comparable to the Great Depression of 1929–31. So that was good. But the policy was then abandoned, and it was only resumed in October 2011, when growth was not happening. Since then, the Bank of England has pumped in a further 175 billion [pounds] into the financial system, and this return to printing money was in fact an implicit admission that austerity had failed to deliver its allegedly magical results.

Now, the first thing to say about quantitative easing is, no one understands how it works. In other words, no one understands what the exact transmission mechanism is from the quantity of money to the real economy. It comes out of the old quantity theory of money, and that was . . . the problem with the old quantity of money theory as well. I suppose, in the crudest form, the quantity theory of money stated that when the central bank buys government securities, the sellers of those securities have more cash than they want, so they spend the excess cash. This causes prices—or, in modern versions, money GDP—to rise. That's as far as it went, really.

The questions are, how does the extra stock of money get converted into spending and how much of it results in increased spending on currently produced output? Because that's what we want to know, for GDP particularly. The official view is that QE operates through two channels: the bank-lending channel and the portfolio-rebalancing channel. As I say, I'm going to abstract from the export channel. This is the Bank of England's view about how it works: You have gilt purchases, and on the downward cycle, you have bank deposits and liquid assets being increased. You have the interest rate being lowered, and then you have domestic demand coming through, being improved. On the other, portfolio-rebalancing, channel, you have a downward pressure on gilt yields, and that means that there is a movement from gilts into securities; so you have a wealth effect, and that also comes into an increased domestic demand. From those two channels you expect this emission of money to increase domestic demand and therefore produce economic growth—to make economic growth better than it would have been.

The lower channel, the bank-lending channel, is quite straightforward. The idea is that, as commercial banks acquire significantly higher levels of reserves they will drop the rate of interest they charge for loans, people will borrow more, and this extra borrowing will revive the economy by a higher investment. The portfolio rebalancing channel, on the other hand, assumes that a bond purchasing program by the central bank will cause investors to switch from bonds to shares, to equities, and the rise in the price of these equities will, through a wealth effect, boost total spending—luxury consumption on the one side, investment, and so on.

But both effects are highly questionable. The volume of bank lending depends on two factors: the balance sheets of the banks and the expectations of the borrowers. If banks have made large losses on existing loans, they're naturally reluctant to make new loans. Equally, if entrepreneurs face falling demand curves for their products after having already suffered losses on their sales, they're more reluctant to borrow to invest in new plants and equipment. So it may be that banks charge a rate of interest for new loans higher than the expected returns of borrowers, who face a flat market. In a slump, both effects operate to block the bank-lending channel. Quantitative easing may ease liquidity constraints on the banks but it does nothing to improve the profit expectations of businessmen. That's *despite* quantitative easing. The rate of interest may not fall sufficiently to balance saving and investment at full employment, and this is the old Keynesian argument.

Stated more formally, if quantitative easing is increasing the money supply, M1, at the same rate as the public—households, banks, and nonbanks—is increasing its saving, the effect of QE on aggregate demand will be zero. And even worse, if businesses use their borrowed funds to pay down existing loans, there may be an actual reduction in the money supply.

You can measure the effect of QE on spending by what happens to M4, or broad money, [and M1, or narrow money]. . . . Before the recession, broad money was expanding faster than the narrow money because of the very strong demand for loans. Since the recession, it's been expanding below. The Bank of England has been pumping away, but in fact, M4 has not responded in the way it thought it would. Other data confirm this. The bank-lending growth rate has stabilized, but it remains negative for businesses and remains well below its historic 5 percent growth rate. This is what's happened to bank lending. You can see they've been trying to boost it through quantitative easing, but it's well below its historical average.

Even recent bank subsidy schemes, like Project Merlin and Funding for Lending, which aims at boosting bank lending to small- and medium-size enterprises, have had little impact. However, the Help-to-Buy scheme, which is a further subsidy to the banks to lend to intending house buyers, is starting to have a positive impact on house prices, though not house construction. This helps to explain the growing feeling [that] the British economy is on the mend. Whenever house prices are rising, there's a big, big good-feel factor injected into people's psychology.

Today, adherents of quantitative easing place most of their hopes on the wealth effect; that is, the wealth effect of portfolio rebalancing. How justified is that? The crux of the problem is that there's no certainty that wealth owners who have swapped their bonds for cash will embark their new money on new investment. That's the crucial missing link.

In *The Treatise on Money*, a book that's very rarely read nowadays but it's full of good material, John Maynard Keynes made a crucial distinction between what he called the "industrial" circulation and the "financial" circulation. Industrial circulation consists of deposits used to maintain the normal processes of current output, including the normal rate of investment, while the financial circulation consists of deposits used for the purposes of finance, such as speculation and stock market operations. The distinction is between buying for a quick capital gain and buying to obtain an income flow over a number of years over the life of the capital equipment.

Interestingly, the financial circulation reappears as Keynes's speculative motive for holding money in *The General Theory [of Employment, Interest, and Money]*. They're not exactly the same, but they're very similar. Dividing up the flow of money into these two channels was designed to highlight the fallacy of treating the financial system simply as an intermediary between savings and investment—simply a mechanism for transferring savings into investment—because part of the savings deposits circulate within a financial sector, which has only a tenuous connection with the real economy.

I think that's the theory, and I think that explains a lot of what the effect of QE has been in practice. The current volatility of the stock, bond, and currency markets bears out the idea that the main effect of QE, certainly as practiced in the UK (it's a bit different in the United States), is to stimulate financial circulation. There's been something of an asset boom going on, particularly on the stock market and parts of the housing market, but this has not spread far into the real economy. Increased spending by the rich has benefited the lower ends of the service sector. Wages—of waiters, cooks, . . . drivers, chauffeurs—have all been sinking, so some spending by the rich on those areas has certainly taken place.

But according to the recent estimates of the Office for National Statistics, production and construction, which is where QE was really aiming, remain well below their precrisis peaks, by 12.8 percent and 12.5 percent, respectively. . . . The other services have done all right, but [many of] these services are actually . . . minimum-wage service jobs, and it's well to remember that. A lot of spending has gone into that, into boutique markets of one kind or another. So the rich have been spending some of their new gains, but mainly they've been speculating in assets.

If the direct results of QE are disappointing, the indirect results are likely to prove even more so. This is because quantitative easing, in the way it's been practiced, skews the distribution of wealth and income further toward those with a low propensity to consume. It does so directly, by placing extra money in the hands of asset owners, and indirectly via inflation and the depreciation of the exchange rate. So really, what's been happening is a shift in national income, which has been going on for a long time, accelerated by QE—a shift from wages to profits. It does depress the purchasing power of exactly those people on whom a strong recovery depends. In the year to August 2013, wages rose by 0.7 percent, but prices grew almost four times faster, at 2.7 percent. With earnings lagging behind prices, the TUC [Trade Unions

Congress] estimates that average real pay has fallen by 7.5 percent since 2008. This reverses what was happening before the recession. . . .

Great, says the neoclassical economist. That's wonderful! Because his theory tells him that the lower the real wage, the more people will be employed. Therefore, falling real wages was always one of the neoclassical mechanisms of recovery working—obviously through increased competitiveness in the external market, but also by lifting profit expectations in the domestic market.

Of course, this is only true if the fall in real wages boosts profit expectations sufficiently to get employers to offer more employment because their animal spirits have been lifted. This has not happened, and in a way it's hard to see how it *can* happen if they face a sagging domestic demand. So far, the result has been a jobless recovery. Unemployment has not gone down, underemployment has gone up, youth unemployment remains catastrophically high at over 20 percent—not as high as in Greece—and the proportion of people living in officially defined poverty has increased by one million, from 12 million to 13 million, in the last three years.

So what is the Bank of England's assessment of quantitative easing? Of course, you'd expect it to be more favorable than perhaps some other assessments, because, after all, it's assessing its own policy—it's marking its own ex ante players. So this is it: it's carefully hedged as you would expect. It says that its asset purchases have pushed up the price of equities at least as much as they have pushed up the price of gilts, and so that could be counted as a success.

In talking about the wealth effect, which it relied on, really, as the main transmission channel, [the Bank] notes that, "crucially, these agents' propensity to spend will depend on whether they think that their additional wealth is long-term or merely a short-term improvement in their economic position." In other words, they don't know. Expectations turn out to be the king of the analysis. And they go on: "To the extent that QE leads to an improved economic outlook, it may directly boost consumer confidence, and thus people's willingness to spend." So, again, they don't really know what its effect is going to be, and economists will debate this for a long time to come.

For its effect on pension funds, the Bank considers the effect to be neutral on fully funded pension schemes because of the fall in gilt yields being balanced by the rise in asset values, but negative for defined-benefit pension plans. Anyway, it's pretty equivocal. . . .

[In terms of] the distribution of financial assets in the UK by age and by household, QE really is directed against the [90th and 95th percentiles]. . . . They're doing well out of QE [relative to median household income]. As for the rest, it's not clear that they're doing at all well, and they may even be doing badly.

My conclusion—very short—is that Osborne's fiscal policy has cost the UK three years of output, and it has damaged productive capacity through prolonged unemployment and hysteresis. Further, QE will not produce a sufficient offset to the effects of fiscal contraction because it accelerates the transfer of wealth and power—wealth and incomes—from the poor to the rich. At best, it will produce a hectic, narrow, largely London-based boomlet, followed by another collapse within a few years. The next collapse may not come until after the next election, and that, of course, is what the coalition is banking on—all right if the collapse comes later, but not before we have to go back to the voters. Meanwhile, to those who have, it shall be given.

Thank you.

NOTE

Martin Hellwig and Manfred Neumann, "Economic Policy in Germany: Was There a Turnaround?," *Economic Policy* 2, no. 5 (October 1987): pp. 137–38.

Q&A

Moderator: Thank you for that. While the microphones come forward I'm going to abuse my privilege of master of ceremonies to ask the first question.

So there are clearly a lot of parallels here, but if you were able to channel the spirit of Keynes to the table with the troika, what are some of the direct lessons that you see for Greece? Or what would be the economic consequences of the troika's takeaway from—

RS: "The economic consequences of the troika"—someone should actually write a book with that title. I think it would be quite a good seller all around Europe, actually.

Look, Greece can't do much on its own. I mean, if you reject the idea of Greece leaving the euro, then the solution to the Greek problem, 70 percent, has to come from . . . other countries in the eurozone. I'd say 30 percent has to come from Greece. I don't accept the view that it's all the eurozone's fault. I think there were things wrong with the Greek economy and the way it was run. But you'd have to have some debt forgiveness. Keynes was very keen on debt forgiveness. It's strange that the Germans never really read *The Economic Consequences of the Peace* [1919], where he was arguing for debt forgiveness for Germany at that time. You have to have a lot of debt forgiveness. You have to have a European investment program—a European-wide investment program. You have to have some rebalancing mechanism of surpluses and deficits. I would say a European clearing bank similar to what Keynes proposed at Bretton Woods (it wasn't adopted), whereby the surpluses of the creditors are taxed at an increasing rate as their surpluses increase. The deficits of the debtors are also subject to tax, but the idea of taxing the creditor was a novel idea; and, in fact, that was too novel for the Americans to adopt.

What we actually have is a situation in which Germany gets a lot of benefits from being in the euro, particularly a lower exchange rate for its exports than it would get otherwise, and is prepared to subsidize the Greeks in order to keep it in and to maintain that advantage. It doesn't keep the Greeks in a lavish lifestyle, but it does enough to prevent a really serious crisis. So Germany pays Greece in order to get a lower exchange rate for its exports. . . . That's a simplified view, but I think . . . that's the core of it. . . .

Q: The UK does control its own currency. Your thesis is, it went through a private borrowing binge where banks lent to people for homes, et cetera. So you had a boom, and you're advocating that now that that has stopped, the state can simply jump in, do some spending itself, and then you can avoid a recession. That seems like a Wonderland, where you can have a boom and then, okay, you don't have the boom continuing, but at least we can still have growth until whenever—until perhaps the next boom comes along. We never have recession; we only have, like, booms.

RS: Yes, well, why is that Wonderland? I mean, do we always have to have recessions as the price of sin? That seems to be your argument. Of course, if you just reignite the old housing boom, you're quite likely to get another collapse. But that was exactly [what] I was saying you shouldn't do, and you missed [the point]. I said of course you shouldn't reignite the housing boom. And the problem with QE was the danger [that] it was doing exactly that. What you should do is actually have a broader-based recovery based on investment—proper investment, in the real economy. There are lots of projects that can be done. There's transport, there's housing, there's education, there's green technology—there are a lot of things that you could do, and the state could actually stir up the damaged spirits of businessmen to do those sorts of things. So that's not Wonderland.

Q: Thank you for an inspiring speech. You expanded on the argument for the intergenerational debt, and you explained the fallacy based on a distributional argument. Isn't there another argument . . . , that it also depends very much on what the debt is used for and that concerns both internal debt and external debt? If you borrow to finance current consumption or a housing bubble, that's one thing. If you use it for investment purposes, the next generation has profitable investment. . . . That might be, I think, a useful message also for Greece: that what you do with debt matters.

RS: I completely agree with that. . . . [If] I leave my daughter some bonds and she cashes them, she is better off—she's got more cash. But someone has to pay. Maybe it's the daughter of someone who was left with no assets at all. So in that sense there's simply a redistribution of assets in the next generation, not a net burden.

However, you're absolutely right. If you can arrange your current borrowing so as to produce assets that the next generation can enjoy, that would be much better than just filling up holes and digging them up again. I mean, this is a phrase of Keynes's that has got into the literature. But he prefaced it. He said, "If you fill up holes and dig them up again, if you pay people to do that, you never need to have any unemployment." But he added, "if you can't think of anything better to do." And, of course, he would have preferred that the borrowed money be spent on producing productive assets—absolutely.

Sessions

SESSION 1

Europe at the Crossroads: The End of Muddle-through

Frank Veneroso, Liz Alderman, Ebrahim Rahbari, Philippe Gudin de Vallerin

MODERATOR:

LIZ ALDERMAN
The New York Times

PHILIPPE GUDIN DE VALLERIN
Barclays

EBRAHIM RAHBARI
Citigroup

FRANK VENEROSO
Veneroso Associates, LLC

GUDIN DE VALLERIN surveyed the economic outlook for the eurozone and discussed options to stabilize the region's economy today and in the future. He emphasized that his remarks were couched in his conviction that the European project is the only viable path forward for the region.

He recalled that the summer of 2012 was a significant milestone. Europe was very close to a breakup of the euro and financial markets were frozen. The economy was in a very deep recession and there was widespread speculation concerning a Greek exit. Three decisions changed the situation: (1) Mario Draghi launched the European Central Bank's (ECB) Outright Monetary Transactions policy; (2) in June 2013 European leaders decided to pursue greater integration in the euro area, starting with the banking union; and (3) the (unofficial) decision to keep Greece in the euro area and to continue to support the country financially. These three developments restored a measure of confidence to financial markets.

Today, the problem is the lack of a growth driver. There are a number of obstacles to growth, including restrictive fiscal policy, a constraint on household income because of higher taxes and lower public spending, weak private investment, and major imbalances in some countries. The corporate sector is still very indebted and will continue to deleverage. Imbalances in the external sector have been reduced somewhat and competitiveness is improving. However, Gudin de Vallerin warned that this process is going to be slow, long, and painful. Overall, global growth prospects are not very promising. In his opinion, the best we can hope for is to see growth go back to approximately potential growth, which in Europe is not very far from 1 percent.

Gudin de Vallerin recalled that the main cause of the crisis was not fiscal policy but macroeconomic imbalances. Within the monetary union, he explained, there is no mechanism to ensure that countries do not diverge; when countries diverge, significant differences in real effective exchange rates arise. In recent years these imbalances have been reduced somewhat. While there have been some reforms, this does not translate into higher exports quickly. The downside of these policies is that the short-term impact is a reduction in domestic demand, and the rebound in exports is not sufficient to balance these negative effects.

Gudin de Vallerin described the outlook as quite bleak and the risks skewed toward the downside. The recovery faces a number of downside risks, including the risk of another global crisis, the unpredictability of the US budget, low inflation in the presence of large volumes of debt, and the risk of deflation. There is also the risk of another credit crunch in 2014. Finally, austerity policies have significant impact on the social situation. Unemployment is running very high in many countries. This creates political tension. Based on these conditions, he turned to a discussion of policy options.

First, the process of creating a banking union must be accelerated to reduce the risk of financial fragmentation, especially for the southern countries. It is urgent that member-states agree on a resolution mechanism, devise backstops to put in place for the asset quality review, and remove the risk of a credit crunch next year. The second important action is support for monetary policy, such as the recent ECB rate cut and the decision to extend the full allotment procedure until mid-2015. Third, Europe must recognize that, although it is difficult and controversial, we cannot get out of this situation without significant debt relief for some countries, such as Greece.

Next, growth is needed. Growth needs to come in parallel with an agenda for structural reform. Structural reforms should not be limited to the peripheral countries. This is part of the rebalancing that many people are calling for. Europe also needs a sensible plan for long-term public investment. And last but not least, we must deepen the integration in Europe because the monetary union cannot work without a significant degree of economic, financial, and political union.

RAHBARI expressed his broad agreement with much of Gudin de Vallerin's comments. He observed that this level of agreement may indicate that the problem is not that reasonable people do not agree on sensible policies, but rather, convincing leaders to implement some of these rational policies is the problem. Rahbari echoed his support for the European project. In Europe, he observed, there are only small countries—those that already know they are small countries, and those that have yet to find out that they are small countries.

Rahbari argued that finding a way to reduce excessive levels of debt is the only way to ensure that Europe is on a path to prosperity. He emphasized that debt, while not bad at normal levels, is bad at high levels as it tends to lead to bad decision making, high tax levels that may have distortionary effects, and, potentially, financial instability and political turmoil. Debt also makes all of the other problems Europe is facing more difficult.

Rahbari cautioned that while there is considerable variability in debt levels between countries, the level of nonfinancial sector debt over the last couple of decades has gone up in almost every country. In this respect, he noted, Germany is a bit of an outlier. The distinction between public and private sector debt sometimes matters quite a lot, but we have learned from the crisis that this distinction is ultimately not clear—that debt can migrate from public to private balance sheets or the other way around.

Europe also faces an enormous, and as yet unaddressed, unemployment problem. Europe has created new problems as a result of its response to the crisis: long-term unemployment, very high levels of unemployment, and higher levels of inequality. In a number of countries, the low level of educational achievement is also a problem.

The banking sector also requires attention. The sovereign exposure of European banks has shot up dramatically. While some progress has been made, there is a valid concern that the banking union will not be nearly as effective as it could be in terms of addressing the lack of funding, the divergence of funding costs, and funding opportunities in much of Europe.

There is also a lack of broad-based support for the kind of deep integration needed to address these problems. A recent survey by the Pew Research Center shows a lack of trust between many European countries, which poses an obstacle to integration. Until greater integration is achieved, Rahbari recommended creating circuit breakers to create a more resilient system to deal with economic shocks without requiring deeper levels of integration.

These three big issues—a banking sector that needs repair, a seemingly intractable labor market situation, and the lack of support for deep integration in Europe over the next few years—are quite severe, but they would be far more manageable if debt burdens were much lower. To address these problems, Europe must rely on a range of fiscal and monetary policy tools, including debt relief. Given current political and economic conditions, excess levels of debt must be dealt with in a manner that is more transparent for both investors and national populations. Several of the most pressing issues are political. Politicians must address structural reform and how to persuade citizens to support it. In every country, said Rahbari, we must make it very clear that "Europe" means we are all one country.

Rahbari concluded that the prospects for a rapid resolution of the problems in Europe remain slim. However, there is an urgent need to act. Compared to the worst days of the crisis, Europe is in a relatively comfortable position. Financial markets have stopped panicking about the prospects of some European countries, but this has made policymakers complacent.

VENEROSO focused his comments on the debt trends and financial dynamics in Europe and the near-term outlook. He recalled that the run on the European banking system in 2012 created a recession. The bank run ended, but there remains a great deal of debt to manage. As a result, there is still a chance for a financial crisis, but of a different sort.

Veneroso recalled that the crisis stemmed from the "fatal flaw" in the euro: a predisposition or vulnerability to bank deposit runs. In 2012, fiscal austerity policies led to economic weakness, markets focused on sovereign debt levels, and a bank run in the periphery followed. Draghi intervened and ended the market panic. Veneroso described Draghi's actions as a triumph of expectations management. However, the recent data on Europe are mixed. There has been a marked loss of momentum and there is the possibility of relapse. The odds may well favor a "muddle through" scenario, and the near term remains uncertain.

Veneroso next explored potential drivers of the European economy. The previous two years were dominated by bank runs and market panics that left private debt in the background. However, European private debt is extremely high and its ratio to GDP has not gone down in recent years. Private debt and falling inflation (or deflation) pose Minskyan and Fisherian threats, respectively. If another crisis occurs, Veneroso argued, it will be Minskyan, triggered by the disappearance of debt-alleviating inflation. If deflation takes hold in Europe, with its sky-high private debt, the region might then suffer a Fisherian debt-deflation scenario. In the absence of a system-wide deposit insurance scheme (the fatal flaw in the euro) a crisis would probably reemerge.

He cited several recent positive economic developments, including industrial production in Portugal and the Netherlands, German retail sales, Spanish retail sales, and improved sentiment across the board. Veneroso attributed these "green shoots" to improved financial conditions following Draghi's decisive action. These events are also partly explained by "austerity fatigue" (i.e., following an extraordinarily deep recession, an economy has a tendency to rebound, at least for a while).

However, these green shoots have recently begun to turn brown. German retail sales are negative, industrial production is weak, and factory orders have been flat for six months. Recent national data do not point to a broad-based recovery. In terms of debt, the data show that private nonfinancial debt in Europe is very high relative to other countries. The firm and household private-debt-to-GDP ratio has barely moved and inflation expectations continue to fall. The money supply, which had improved, is starting to contract. Today, the most important trend is that private credit growth is more negative than at any time in the whole cycle, due in part to a smaller ECB balance sheet. Veneroso observed that it may be that current policy is making things worse. Specifically, as banks become more restrictive, and with the implementation of Basel III capital rules, we are making the situation worse. However, the real problem may simply be too much debt and bad demographics.

Europe's high debt levels may be linked to the welfare state. By supporting income, the welfare state may have fostered a pervasive moral hazard that distorted the risk protections of lenders and borrowers. This is an idea that Hyman Minsky touched on in *Stabilizing an Unstable Economy.* To the extent that Europe reduces these supports, it is undermining the conditions that made people willing to lend and to borrow. If you change the perception of the welfare state support but the debt legacy remains, then an untenable situation results. This might explain falling inflation, falling inflation expectations, and, even more so, declining real private debt. If this is true, said Veneroso, then Europe faces an ongoing problem.

SESSION 2
Will the Periphery Survive in the Euro?

Yannis Aggelis, L. Randall Wray, Jan Kregel, Elias Kikilias, Rainer Kattel

MODERATOR:

YANNIS AGGELIS

Kefalaio and Capital.gr

RAINER KATTEL

Tallinn University of Technology

JAN KREGEL

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National Centre for Social Research, Greece

L. RANDALL WRAY

Levy Institute and University of Missouri–Kansas City

KATTEL addressed the false perception of the Baltics as "proof" that austerity leads to growth. Kattel noted that the Baltic countries, especially Estonia, have been used as examples of how and why austerity works in Europe, and why countries like Greece, Spain, Portugal, Ireland, and others should follow their example. He explained that the recovery in the Baltic countries has almost nothing to do with austerity and almost everything to do with some form of Keynesian stimulus. These facts remain largely hidden from the public press and economists.

Kattel began with a comparison of basic statistics on Greece and Estonia. He recalled that, unlike Greece, Estonia had virtually no public debt. In terms of GDP growth and GDP per capita, Estonia entered and exited the crisis very quickly, whereas the process of recovery has been very slow for Greece. In terms of labor productivity, Greece and Central Eastern European states (there is no longitudinal data for Estonia) there was a catching-up process that occurred during the 1980s through the early 2000s. Kattel noted that a closer investigation of the statistics reveals important differences.

Greece has received far more total foreign direct investment than Estonia, but Estonia has received far more on a per capita basis. The Baltics have received enormous amounts of foreign direct investment, first in manufacturing and then in finance and real estate. The process of financialization in the Baltics took place over a 15-year period. Thus, firms that would have in the past expanded into Greece, Portugal, or Ireland instead expanded into the Baltics. This development undercut the economies of the southern periphery. Estonia also had a positive trade balance for goods and services that require more highly educated labor as compared to Greece. Using learning organizations (i.e., firms in which independent workers can accomplish a range of complex tasks) gave the Baltic countries an advantage. Kattel noted that Estonia has a far higher proportion of such firms, which helps to explain the relocation of firms from countries such as Germany, Finland, and Sweden. This is a critical difference between Greece and Estonia. The relative deficit of firms relocating to countries such as Greece meant that southern peripheral countries were slower to catch up to Europe as a whole.

In terms of the size of government, Estonia is very small in comparison to Greece. When the crisis hit, Estonian firms began to increase exports and government began to engage in spending while holding deficits low. Kattel presented data on Estonian public spending that clearly demonstrated that there was no fiscal austerity in Estonia; rather, the opposite was true. As a result of payments for pollution reduction under the Kyoto Protocol, Estonia had considerable fiscal latitude. Further, Estonia benefited from the European structural funds to a greater degree than Greece, Portugal, or Spain. These two funding sources accounted for 20 percent of Estonia's spending in 2012.

Kattel next examined the differences between the Baltics and Greece in terms of export destinations. If one compares the three major export destinations for Greece (Germany, Italy, and Russia) and Estonia (Finland, Sweden, and Germany), one notes that exports are an enormous part of the Estonian economy (25 percent). Further, Estonia's trading partners engaged in aggressive stimulus or had very strong export markets. Estonia benefited because it is closely integrated with its trading partners. However, even with this high degree of integration, Kattel cautioned that while a great deal of production is located in Estonia, it does not create the inputs for this production domestically. For this reason and the other reasons cited above, Estonia's export success is difficult to replicate. Kattel concluded that the lesson we should take from the Baltics, and specifically the case of Estonia, is that their development in recent decades in no way argues for austerity.

KREGEL explored the applicability of Hyman Minsky's theory for understanding the evolution of the Greek crisis and ways to emerge from that crisis. Specifically, can we analyze the current crisis in Minskyan terms or does it look more like the traditional crisis that we saw in Latin America, in particular in Argentina, in the 1990s (aka a Washington Consensus crisis)? While Latin America did not have a troika of international lenders imposing economic policies, the kinds of policies that were instituted in Latin America by the multilateral financial institutions, in particular the International Monetary Fund and the World Bank, look surprisingly similar to the kinds of policies that have been imposed on the Greek economy and have produced similar results. Kregel then posed a second question: why did Argentina manage to emerge from the crisis with virtually a decade of growth, which was in excess of Argentina's growth potential, whereas Greece has not yet managed to produce the same type of positive growth response?

Kregel offered a brief survey of Minsky's contributions to the analysis of economic instability and then reviewed the conditions in Greece prior to the crisis. He observed that the twin shocks that precipitated the crisis were the restatement of Greek debt and the failure of financial institutions to continue rolling over Greek debt—a "Mediterranean 'Minsky moment.'" Kregel observed that the typical response to such events would be for the central bank to backstop asset prices or government fiscal policy to support income. However, neither of these actions was possible under the European Union (EU) treaties. The result was a Minskyan-Fisherian debt deflation. This leads to an upward interest rate spiral, and, when compounded by an austerity policy of internal adjustment, to wage and price deflation, while the outstanding debt remains unchanged in nominal terms.

In comparison, the Latin American crisis in the 1980s resulted in a lost decade. Latin American economies recovered by using structural adjustment policies that involved setting an exchange rate anchor. This is what Greece effectively did when it adopted the euro: it effectively adopted the equivalent of the Argentine Currency Board. This led to price stabilization, and also to a sharp overvaluation of the currency. At the same time, there were rising capital inflows, and, within the structural adjustment countries, the impact of the structural adjustment was to generate a very sharp increase in capital inflows; this process was also observed in Greece. The idea in Greece and Argentina was to create confidence among investors that there were fiscal surpluses sufficient to ensure debt repayment, and thus encourage investors to continue to lend. The cuts in government expenditures, tax increases, and the like that were applied in Latin America have been applied in Greece, and with similar results. The policies have undermined spending and investor confidence and increased debt ratios.

In the face of the failure of the Washington Consensus policies, Argentina introduced a parallel currency and defaulted on its government debt, which meant that it immediately went into fiscal surplus. It became a government that had the ability to meet its expenditure targets, and it had the ability to make domestic expenditures in order to support the economy. The exchange devaluation generated an external surplus. Argentina found itself with a dual surplus (i.e., a fiscal surplus and an external surplus), which was used primarily to increase domestic wages—the opposite of the Washington Consensus policies. The result was a very rapid recovery in both incomes and employment.

Kregel concluded that the Greek crisis looks very much like a Minsky crisis (i.e., stability leading to instability) and a Washington Consensus crisis (i.e., the remedies made the situation worse). Knowing this, Kregel asked, why should we persist with policies that we know do not work? The basic question becomes, is it possible to reverse the austerity policies within the context of the euro, provide the kind of recovery that Argentina managed to introduce, and reverse the decline in Greek income and employment?

KIKILIAS observed that the characteristics of Greece and the Greek crisis are common to almost all of the countries in the eurozone periphery. The mainstream view of the eurozone crisis is that it was due to a lack of competitiveness in the European periphery resulting from excessive increases in labor costs in those countries. According to this view, exports became uncompetitive and external balances deteriorated during the last decade. This diagnosis of the crisis leads, Kikilias argued, to policy responses that aim to improve competitiveness through internal devaluation (currency devaluation is not possible in a monetary union).

Kikilias noted that the deterioration of external deficits in periphery countries was not due to reduced competitiveness. His analysis shows that in the years prior to the crisis, countries in the periphery with rising unit labor costs also recorded increases in exports. Contrary to the prevailing stereotypes, only

France and Finland saw negative export performance and surplus countries saw only small relative increases in prices (e.g., Austria, Germany, and Finland). Nonmarket goods, particularly construction, explain the increase in labor costs. Therefore, the decline in the foreign accounts reflects a demand shock in their domestic sector, not a competitiveness shock.

Kikilias argued that the Economic and Monetary Union (EMU) and the current euro have been established on a fundamental economic asymmetry: the North, with high productivity and investment levels, and low consumption and trade deficits; and the South, with exactly the opposite—that is, high unemployment, external deficits, and debt. This asymmetry has been exacerbated by wage suppression in some euro countries.

The common-currency framework prevented countries from maintaining persistent deficits or surpluses. As a result, trade surpluses and monetary integration led to huge capital flows into the periphery countries, leading to increased domestic demand, rising prices, and rapid increases in imports and wages. This loss of competitiveness was due to exchange rates and rising wages in the international sector. Today, Greece has a much smaller international sector, and the remaining loss of competitiveness is due to the oligopolistic restructuring of the market. The policies followed since 2010 have produced a generalized economic contraction. At the core of the economic crisis is the fundamental economic asymmetry in the eurozone and a lack of investment versus saving for all those countries of the EU where funding is limited. It is impossible to concurrently reduce external and internal deficits across all the eurozone countries based on current policies, especially the policies of the powerful countries, unless the surplus countries either increase their imports or reduce their trade shares. This is complicated by the fact that these countries are the most competitive and show exactly the opposite trends.

This asymmetry is also manifest in the levels of unemployment and poverty. Kikilias argued that poverty and unemployment must be treated as explicit policy targets, not as secondary phenomena. Europe needs an adjustment mechanism to keep trade balances at an acceptable level and restart the economy by strengthening weak economies through investment. Further, Europe needs a framework for social protection with a source of funding; it must change the strategic direction of investment policy and develop new comparative advantages. In closing, Kikilias argued that the real engine of economic growth and development is the middle class and working people. Economic growth requires investment in jobs, employment, training, knowledge, education, and opportunities. Ultimately, he concluded, it is the purchasing power of working people and the middle class that creates jobs.

WRAY explained that the current crisis is mostly a financial crisis driven by trends in the private sector. The underlying problem was private sector debt and lax lending standards by banks (i.e., the same kind of activities seen in the United States that brought about the global financial crisis). Wray argued that the EMU was designed to fail, since nongovernment deficits, both external and internal, create budget deficits. These deficits are a problem for the EMU but not for sovereign currency countries like the United States. Many have noted that the fatal flaw in the euro was the lack of deposit insurance, but it is less well understood why these nations cannot have deposit insurance. The reasons relate to sovereignty, and how a nation gives up its sovereignty when it adopts what is essentially a foreign currency, as was discussed by Kregel in relation to Argentina.

Many continue to argue that budget deficits (or so-called "profligate" government spending) were the problem leading up to the global financial crisis. To understand the fatal flaw of the euro requires a Modern Money Theory approach, which follows in the tradition of Minsky, Wynne Godley, Charles

Goodhart, and, before them, John Maynard Keynes, John Knapp, and Harold Innis. Wray next explained why current account deficits create a problem if you do not control your currency as a sovereign issuer.

When individual European countries adopted the euro it led to the false conclusion that all nations were equivalent. In fact, individual European countries were and are quite different from one another. And, as a result of losing their ability to issue currency, they are effectively much more like US state governments. There are crucial differences between US state governments and the governments of EMU member-states. However, the lack of monetary sovereignty by states, and now eurozone members, is instructive. There was probably a belief in the eurozone that, if conditions became intolerable, the European Central Bank would do what it has promised it will never do—that is, rescue individual national governments. This is the fundamental problem of the euro.

Wray closed with an observation made by Godley in 1992: "The power to issue its own money, to make drafts on its own central bank, is the main thing which defines national independence. If a country gives up or loses this power, it acquires the status of a local authority or a colony." So you have to ask yourself, said Wray, which are the colonies now?

SESSION 3

The Financial System in the Eurozone and Greece: Dysfunctional or Built to Last?

Gerasimos Arsenis, Emilios Avgouleas, Matina Stevis, Dimitri Vayanos, George S. Zavvos

MODERATOR:
MATINA STEVIS
The Wall Street Journal

GERASIMOS ARSENIS
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GEORGE S. ZAVVOS
European Commission

ARSENIS opened his remarks with several observations on the political aspects of the current banking crisis. In contrast to other eurozone countries, the crisis in Greece was first a fiscal crisis and then became a banking sector crisis. The deep recession, reduction in deposits, inability to find loans on the money market, and increase in nonperforming loans were threats to the banking sector. The rescue of Greek banks was accomplished by transferring 200 billion euros, or 100 percent of GDP, to the banks. Thus, the continuing crisis has exacerbated the debt situation even further. The only viable solution appears to be a European banking union.

Arsenis argued that it is vitally important that Greece establish a healthy and transparent banking system to serve economic growth and development. Recovery of the economy is the first step, but development should not be measured exclusively by GDP growth. Development is achieved through harnessing the economy's productive forces to achieve self-sustaining growth. Toward this end, Arsenis offered three proposals to guide reform of the Greek banking sector.

First, development requires both long-term and short-term financing. Therefore, Greece needs new financing tools and specialized banks to support innovation in fields that improve its competitiveness and its foreign account balance. Second, these new activities will likely entail uncertainty, which increases the cost of financing. This problem should be dealt with in cooperation with the European Union (EU) and the European Investment Bank. Third, a modern banking system that serves development cannot operate in an indebted country. Greece must write off some or all of its public debt. Next, Arsenis discussed aspects of the historical development of the Greek banking sector and the implications for reform. He posed the question, why have there been so many efforts in the postwar period to achieve development or growth that failed or were never completed?

Arsenis argued that the process of development in Greece has been consistently blocked by a closed circle of power and influence, and he recounted examples—notably, the American aid and frozen credit problem following World War II. Between 1947 and 1954, the United States provided virtually zero-cost financing to the Greek economy in the amount of $2 billion in 1947 dollars. This credit was channeled to 10 well-known industrial enterprises, which absorbed 60 percent of the total credit. To this day, 65 percent of the debt has not been repaid. Some have argued that the vast majority of postwar industrialists expanded their operations by using the capital inflow.

More recently, the stock market bubble and the current crisis opened up money markets as a new way to appropriate social resources. From 1995 to 2000, many companies overstated their assets and embellished their balance sheets; the government also contributed to this artificial euphoria. And then the bubble burst. To deal with the crisis, Greek banks needed guarantees from the Hellenic Republic in order to refinance loans. Once again, the cost was rolled over to the state, resulting in the most recent crisis. Greece provided guarantees and recapitalization of about 200 billion euros, or 100 percent of Greek GDP, to the banks.

Arsenis's basic conclusion was that all development efforts in Greece eventually hit a wall of power and influence comprising politicians, bankers, entrepreneurs, and people in the mass media. He cautioned that the composition of these elites changes, but through time they maintain their basic feature: active intervention in public policy for private gain. If Greece wants development, it must break this ring. He concluded that the banking system must be purged of the parasites and the antidevelopment actors who have prevailed for so long. Real modernization of the banking system is not just an issue for technocrats; it is a deeply political issue and requires a radical change in Greece's political system.

AVGOULEAS argued that the crisis in the eurozone arose because of the lack of a single supervisory entity, which allowed individual banking authorities to do whatever they wished. There was also a crisis of competition and huge payments imbalances. Countries with trade and fiscal deficits were in the same monetary union as countries with trade and fiscal surpluses. Surplus funds were invested and became booms in the real estate market in Ireland and Spain, and, of course, in Greek or Italian bonds. These unchecked imbalances within the eurozone led to nonperforming loans and levels of sovereign debt that could not be serviced.

Avgouleas observed that monetary unions typically have fiscal transfer mechanisms. This is true in Germany, the UK, and the United States, where transfers routinely occur between the central and local levels of government. He suggested that the reason the eurozone lacks proper institutional mechanisms is an overreliance on the idea that the "market knows best." Perfect markets do not need institutions for a monetary union. Thus, markets "know" Greece should borrow at interest rates that are 100 percent more than what Germany pays. However, this does not solve the problem of what to do when asset bubbles burst—the victims are usually working people and families, not abstract numbers.

Turning to economic growth, Avgouleas noted that banks and capital are the most important lever for development in the US economy. This is also true in the eurozone. However, in the United States, if private banks do not make loans there are other means for businesses to obtain financing. This is not the case in the eurozone. Avgouleas argued that it is critically important for European banks to start supporting small- and medium-size enterprises (SMEs) if Europe is to recover.

Avgouleas discussed ways in which the European Stability Mechanism (ESM) might be applied to recapitalize the banks. In the United States, monetary policy was used to create a market of last resort as a means to indirectly bail out the banks. Rather than supporting individual institutions, and assuming the risk that this entails, the Federal Reserve bought assets with state money. Likewise, the ESM could employ special-purpose vehicles financed with European Central Bank (ECB) money to purchase troubled assets at a discount from banks. Under this plan, the banks would maintain a stake in the assets they sell and ECB funding would come with a five-year term. If the value of the ECB's purchases were to rise, then the stakeholders would make money; if the purchases lost value, then the ESM would take ownership. As a result, the ECB and the banks would no longer carry troubled assets on their balance sheets and the ESM would absorb losses gradually using fiscal mechanisms. One of the main benefits of this approach is that it creates time for the financial system to gradually sort out its balance sheets.

The legality of such a proposal is subject to interpretation under the "no bailout" clause of Article 125 of the ESM. Avgouleas argued that the ESM is no more likely to run afoul of the rule than the ECB's Outright Monetary Transactions, which were judged to be within the law. It is essential to the euro project that banking assets recover, so that lending can resume to SMEs, households and other economic undertakings at a rate similar to the levels before 2008. If the eurozone cannot achieve this in the next five years, Avgouleas concluded, it is unlikely to survive.

VAYANOS began with a review of some of the key credit cycle trends in Greece. He noted that Greece started from a fairly low ratio of loans to GDP and then grew rapidly. An International Monetary Fund study found that shortly after Greece joined the euro, private credit became more important than the other drivers of growth. Thus, the boom was driven, not by government spending, but by private credit. Specifically, the expansion of private credit saw rapid growth in loans to households and SMEs, many with limited credit histories. In the run-up to the crisis, Greece had the most rapid expansion in lending to households in the eurozone.

The data on investments in government bonds show a massive lack of diversification across the eurozone. For example, based on 2011 data, Greek banks held almost 100 percent Greek bonds. In comparison, French banks held 40 percent in French bonds and Irish banks held about 70 percent in Irish bonds during the same period. From 2008 to 2010 there was a marked increase in the exposure of Greek banks to the Greek government, rising from 35 billion euros to 58 billion euros. Private sector involvement losses were 38 billion euros, effectively rendering Greek banks insolvent. If Greek banks had been holding a well-diversified government bond portfolio, insolvency could have been avoided. Vayanos's analysis suggests that this risk in the banking system was the result of state pressure on the banks. He next discussed the credit crunch and the process of deleveraging.

The credit crunch is directly related to nonperforming loans (NPLs). Greece has the second-highest percentage and is the fastest-growing holder of NPLs in the eurozone. As a result, it is experiencing a severe credit crunch, and conditions are deteriorating rapidly. In terms of deleveraging, Spain and Ireland have reduced their balance sheets through the creation of "bad banks" to take on NPLs. In contrast, Greece, Italy, and Portugal have not seen the same kinds of reductions. Vayanos explained that the creation of public bad banks creates incentives to resolve NPLs, whereas banks are more likely to engage in the practice of "extend and pretend" to preserve their regulatory capital if they do not have the option of moving NPLs off their books.

Greece opted not to create a public bad bank, citing an illiquid market for its heterogeneous portfolio of loans and a lack of funding to create such an entity. However, it must find a uniform and transparent means to resolve NPLs. It is clear that Greece will not be able to grow without a functioning banking system. Vayanos next examined aspects of the bankruptcy code that have created obstacles to recovery.

The "Katseli law," which was passed in 2010 to address mortgage foreclosures, contains many sound principles, but the implementation of the law complicates the resolution process. The process is slow, creates strong incentives for "strategic default," and is overseen by less-qualified courts, which leads to a lack of uniformity in decisions. The law also undermines the principle of collateralized lending by preventing foreclosures. Rising real estate taxes also exacerbate problems in the credit market by lowering home values. Collateral value decreases trigger increases in distressed loans, which harm future growth. A perverse consequence of this policy is that some of the proceeds of the increased taxes will eventually cover the losses that banks incur because of reduced collateral values.

Vayanos closed with a discussion of the relationship between financial development and economic growth. The term "financial development" refers to the quality of a country's financial markets and institutions (e.g., regulations and investor protections). Greece has made some progress in investor protection but still compares poorly with much of the eurozone. This results in high capital costs for firms, which reduces investment, new market entrants, and, ultimately, competition.

In conclusion, Greece's main objective in the short and medium terms should be to promote the efficient resolution of nonperforming loans and to have a well-capitalized banking system. Greece should also address longer-run issues, including the efficient design and enforcement of investor (and borrower) protection laws, improving financial regulation, and cutting the links between politicians and banks. The state has a role in a well-functioning financial system, said Vayanos, but state control should be avoided.

ZAVVOS discussed how a European banking union could prevent a geopolitical schism. Specifically, his presentation addressed the implications of the political union for the Greek banking system, and the relation between a banking union and the political union. Fragmentation of European financial markets poses a dangerous threat to the EU economy. The Maastricht Treaty was founded on a dangerously asymmetric institutional design and lacks any understanding of Minsky's financial instability hypothesis. Zavvos argued that Europe needs a powerful banking union to absorb shocks to the financial system. A well-functioning banking union is the first step toward greater integration, democracy, and stability. The European Banking Union is a vehicle to develop a financial system based on new and sound principles, adjusted to the domestic needs of its members.

The first step is the restructuring and recapitalization of the Greek banking system, because for the next 12 months, the ECB will work with the Bank of Greece to complete a comprehensive assessment of the Greek banking sector.

The second step is to reinforce the institutional and supervisory infrastructure. The European Banking Union must not allow casino-style banking. There must be a single supervisory mechanism that empowers the ECB as the chief European supervisor. This will create a dynamic symbiosis between the ECB and the Bank of Greece. The Greek central bank will become a component of a federal supervisory mechanism. One of the stated goals of the European Banking Union is to free banking supervision from national politics, improve the governance of banks, and challenge the vested interests in public policy and the corporate sector.

The third step is to establish a new bank recovery and resolution regime for Greek banks, including new laws to integrate the European directives into the Greek legal system. This will include new bail-in rules, the establishment of a Greek recovery and resolution authority, the creation of a national resolution fund, national public backstops, and the adoption of a revised deposit guarantee system.

The fourth step is to ensure financing to rebuild the physical and human capital to encourage economic recovery in Greece. SMEs are essential to the Greek economy, and banks should play a major role in financing them. The fifth step, said Zavvos, is the rebalancing of Europe. The European Banking Union will reduce the fragmentation of the financial markets and create opportunities for Greek banks.

In the midterm, the European Banking Union will help to balance surpluses in some countries with member-states that are starving for cheap finance. An important litmus test of the banking union will be rebalancing access to finance between the northern and southern member-states. The banking union will have the capacity to reduce the exorbitant divergence between banks, funding costs, and lending rates, which currently depend on the country of establishment.

Zavvos closed with some remarks on the transition from a banking union toward a European political union. The EU's ongoing banking reforms will rebalance the relation between markets and politics. Europe must frame capitalism within rules of political authority and advance democracy at a supranational level. The current lack of democratic participation can be met by building strong and accountable supranational institutions capable of delivering public goods, such as financial stability. These institutions should be embedded within a European federation guaranteeing the rule of law, the dispersal of power, and active citizen participation.

Zavvos noted that small-state survival is dependent on more than economic performance. The power of politics over markets should spur small periphery states like Greece to seek the safety of a solid political union and federal structures. Small states, he warned, are the first victims of a lack of strong European institutions. The European Banking Union is a fundamental change because it reverses the dominant political dynamics regarding sovereignty and subsidiarity that assigned supervisory powers to national authorities, and it advances the process of European unification.

SESSION 4

A Union of Austerity or a Union of Growth?

Robert W. Parenteau, Jörg Bibow, Michalis Panagiotakis

MODERATOR:

MICHALIS PANAGIOTAKIS

The Daily Avgi

ROBERT W. PARENTEAU

Levy Institute and MacroStrategy Edge

JÖRG BIBOW

Levy Institute and Skidmore College

PARENTEAU argued that the conceit of neoliberal economics is likely the primary flaw of the eurozone regime. There is a strong, even religious, belief that changes in relative prices will always guide economies back to a full-employment growth path. We know from the work of John Maynard Keynes, Hyman Minsky, and Irving Fisher that price adjustments often lead economies away from, not closer to, full employment growth paths, Parenteau said. This faith-based economics created the need to come up with a calculated misdiagnosis of the crisis: fiscal deficits and public debt profligacy. In fact, the economic contraction was so severe because of private sector spending in excess of income growth. This led to a balance-sheet recession (i.e., a watered-down version of the debt-deflation cycles discussed by Keynes, Minsky, and Fisher).

The misdiagnosis of the crisis also limited our ability to find solutions. For example, expansionary fiscal consolidation is not antithetical to economic expansion, but it applies only under very special conditions (i.e., interest rates must fall sharply as the fiscal deficit is reduced in order to drive up private spending; the exchange rate must fall such that the balance of trade improves). The conditions for expansionary fiscal consolidation did not apply in the eurozone, and an austerity trap was the result.

Parenteau argued for a coherent stock-flow macroeconomics that uses this financial balance approach to describe the austerity trap. The austerity trap is the result of the domestic private sector trying to net save while the government is trying to reduce its fiscal deficit. As a result, nominal income and real output will decline, as we have seen in Greece. Parenteau next offered his proposals for ending austerity without forcing an exit from the euro. The key problem, he argued, is to regain control over fiscal and monetary policy tools without leaving the euro system. There are two public financing possibilities: introducing the G-note and reclaiming the banks.

The G-note is a government created zero-coupon note that is a perpetual note, transferrable, denominated in euros and in amounts suited to daily transactions. The G-note would be used to pay government employees, suppliers to the government, and beneficiaries of transfer payments. In return, the government would accept the G-note as a payment for taxes, thereby creating the demand for G-notes. The main advantage of the G-note is that it allows the government to define its fiscal policy position. The Greek government could, for example, finance an employer-of-last-resort program, or encourage import-competing infrastructure investments. Parenteau cautioned that for the G-note to work, Greece must improve its tax enforcement system, and develop a better distribution of the tax burden so that there is more equal demand for these G-notes across the economy.

The second approach is for Greece to reclaim its banks. Greece could nationalize its banks instead of recapitalizing them. Further, since banks create money by crediting money to an asset seller's bank account, this mechanism could be used to regain control of fiscal policy. Another approach would be to force the banks to become captive buyers of government debt. Government debt has a zero-risk weighting, so there is no bank capital constraint. Greece could then effect the necessary private debt write-offs.

Parenteau closed with a call to reject the suicidal economics of neoliberal austerity. Greece must reclaim its democracy and break crony capitalism. We are limited not by government finance, said Parenteau, but by our imagination, our courage, and our willingness to collaborate. A better world is possible, but we must realize the nature of these neoliberal lies, take back our power, and work together to build our future.

BIBOW argued that the current euro regime is flawed, dysfunctional, and not on a viable track. A fiscal union through a European treasury is the missing element to secure public investment in Europe. It would act as a backstop for the banking union and support the functioning of automatic stabilizers at the national level. A euro treasury is also a recovery strategy that could provide both needed stimulus and symmetric rebalancing. Europe must reestablish at the center the link between the fiscal and monetary authorities that is currently missing.

The most recent crisis demonstrated how the eurozone is defenseless in the face of a serious financial crisis. Under the current regime, national banks are reduced to colonial status and the European Central Bank is vulnerable because it is not backstopped by a treasury. The Stability and Growth Pact and the European Fiscal Compact have only made the situation worse by adding constraints to the operations of national finance ministries. These policies were informed by a misdiagnosis of the problem (i.e., that fiscal profligacy was the source). Today, we have an unworkable regime that can only function by running persistent, sizable current account surpluses—essentially the German model. If the eurozone cannot run persistent external surpluses and the public sector is committed to balanced budgets, the eurozone will be stuck in permanent recession—an austerity trap.

Bibow proposed a plan for a European treasury. As outlined, the Euro Treasury would have three main functions: (1) securing public investment to ensure that Europe has the public infrastructure it needs; (2) providing a fiscal backstop; and (3) anchoring stabilization policy at the national level. His plan provides the element missing in the Maastricht regime, secures public investment, establishes low borrowing costs for all member countries, and offers a much-needed mechanism to enforce fiscal discipline among member-states. The plan relies on a fiscal union but not on a transfer union.

The Euro Treasury plan would pool public investment spending at the center, funded by Euro Treasury securities. The eurozone's public investment would be based on member states' GDP shares. The Euro Treasury would have the power to tax, and member-states would contribute on the basis of their GDP shares. Under this plan, member-states would balance their current budgets (i.e., their structural current budgets), while their capital budget would move to the center. If a member-state failed to balance its structural current budget, its investment grants would be cut. Thus, the much-needed deficit spending would come from the center while promoting low debt ratios at the national level.

A European treasury would also foster recovery through public investment. Member-states would no longer have to balance their entire budget, only their structural current budget. The change in the division of expenditure activities would also act as a stimulus. Further, there would be an indirect stimulus from markets as they realize that national public debts are on a declining trend. Interest rate spreads should come down dramatically and further support the recovery. Also, with a European treasury, interest rates across the union should all be marked against a common benchmark and thus moderate borrowing costs. Finally, under this proposal, Germany would experience a massive stimulus, which is important for symmetric rebalancing, and see higher inflation and more domestic demand growth.

The question of what to do with national debt legacies remains a question, observed Bibow. Since the Euro Treasury plan is a fiscal union, not a transfer union, it cannot deal with this issue. Nonetheless, Europe must have a treasury if it is to recover in a balanced and sustainable manner.

SESSION 5

The Challenge of Unemployment: Can Current Policies Work?

Massimiliano La Marca, Rania Antonopoulos, Maria Karamessini, Christina Kopsini, Duncan Campbell

MODERATOR:

CHRISTINA KOPSINI
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LÁSZLÓ ANDOR
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DUNCAN CAMPBELL
International Labour Organization

MASSIMILIANO LA MARCA
International Labour Organization

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Levy Institute

MARIA KARAMESSINI
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ANDOR addressed the conference in a prerecorded video. He described the challenge of unemployment as "a hard upward struggle to reconcile the need to restore public finances with the need to support growth and maintain social protection." Andor identified the source of the unemployment problem in the original design of the euro area. He noted that while the European Union (EU) has improved the coordination of fiscal and structural policies and provided emergency lending, fiscal consolidation and internal devaluation have had severe social and economic impacts. The experience of countries like Greece and Portugal should also teach us to take a longer-term view of how the economic and monetary union operates. An important step toward this goal is to improve the oversight of employment and social issues, strengthen the coordination of employment and social policies, and improve dialogue, at both European and national levels.

Toward this end, the European Commission has developed five key indicators of employment and social conditions: unemployment, youth unemployment and inactivity, gross household disposable income, the at-risk-of-poverty rate, and income inequality. Using these indicators, and as part of the established processes of economic policy coordination, the monetary union will ensure that the euro creates benefits for all member countries, said Andor. Collective action by the monetary union might, one day, rely on a common budget.

Andor provided recent examples of actions being taken to address these issues. He cited the agreement by EU leaders to allocate 6 billion euros to the youth employment initiative, which contains countercyclical elements. Andor described this program as a key structural reform. However, it is insufficient to address either the youth unemployment crisis or the larger economic and social crisis. In the longer term, the EU needs an autonomous euro-area budget to create fiscal capacity to help member-states absorb asymmetric shocks.

Political acceptance of such a scheme requires that it avoid lasting transfers between member countries, in order to prevent net losers or net beneficiaries. It will require greater shared sovereignty and wider competence at the level of the monetary union; these changes imply treaty changes. Andor concluded that the monetary union must take such steps to ensure its longer-term sustainability and must begin by laying the foundations of such a system today.

CAMPBELL described current labor market trends in Greece as "bad but getting less bad." For example, a recent report from the Bank of Greece stated, "The rate of increase in unemployment is diminishing." However, Campbell noted that it is still possible that unemployment could reach 30 or even 34 percent. Job loss rates remain high, and the chance of finding a job has decreased in recent years. Overall, the Greek labor market remains in dismal condition. These trends can be attributed to structural unemployment (i.e., lost skills, lost work discipline, and so on due to prolonged unemployment). Structural unemployment is not as responsive to macroeconomic policies compared to cyclical unemployment. Education, training, retraining, and the like will be needed to address structural unemployment. Campbell noted that while the International Labour Organization (ILO) does not have much data on structural unemployment in Greece, the long-term unemployment rate among those currently unemployed—roughly 67 percent—makes it safe to assume that Greece has a profound structural unemployment problem.

Campbell cautioned that increased employment numbers are good news if they measure new employment appropriately. For example, if a white-collar worker loses their job and takes a blue-collar job this is an increase in employment but lower use of human capacity. The quality of the new jobs created in Greece is therefore critically important.

Turning to productivity, Campbell argued that Greece's issues are not due to a lack of competitiveness. While unit labor costs (i.e., productivity plus wages) shot up in Greece in the first decade of the 2000s, today, unit labor costs are down. There has been a 22 percent decline in the minimum wage, a 32 percent decline in the youth minimum wage, and a general decline of 15–20 percent of real wages as a result of the crisis. This improves unit labor costs but does little to improve the labor market.

Campbell further argued that wages are perhaps the least important component of competitiveness compared to the rest of the Greek economy. Product market regulation, bureaucracy, export diversification, and stagnation of the manufacturing sector all rank higher than wages in terms of their impact on competitiveness. He explained that wages have been used as a policy instrument because they are easier to affect than other macroeconomic variables. Also, German wage repression is seen by some as a desirable strategy and is being attempted in the Greek labor market.

The results of wage repression are clearly visible in the consumption channel—the main component of aggregate demand in an economy. Depressed wages lead to a prolonged recession. The economy cannot recover if people have less income to spend or lack the confidence to spend when they do have money. Consumption is further depressed by little or no reduction in prices. Finally, the long recession has caused people to deplete their savings, and pension reductions have also lowered consumption.

Campbell next described the significant problem of unpaid work. The ILO counts unpaid workers as employed, but they are not truly employed if they are not being paid. There is also the problem of undeclared work (or "informality"). He warned that many people are working without social protection coverage because their work is undeclared. This appears to be a large and growing problem.

Campbell described Greece's current position as that of a wage-led economic depression. The central issue for Greece is that wages have been reduced so much that there is relatively little consumption or investment in the economy. He concluded that it might take decades for Greece to return the labor market to 2007 levels. The labor market depression has been devastating. Young people who cannot find work for a long period of time are unlikely to earn the incomes that they could have had if they had been able to enter the labor market sooner. In addition, these workers will bear the other physical, psychological, and emotional problems that come along with unemployment. Campbell concluded that Greece will likely return to growth in 2014, but that this is unlikely to have any significant effect on the labor market anytime soon. Hopefully, the troika will soon recognize the employment crisis as the top priority.

LA MARCA presented a macroeconomic analysis of the Greek economy using a financial balances approach. He began with the net lending position of the external, private, and government sectors. He noted two periods of current account deficit, one in the 1980s and another in the early 2000s. La Marca argued that the current account deficit is in some respects structural, and therefore not very sensitive to price adjustment. While the causes of the deficit were different in the 1980s and the 2000s, it can be shown that price adjustment played a minor role in both.

The big difference between the first and second deficit waves is that during the first wave there was both a current account deficit and a surplus in the private sector, and the entire domestic sector deficit was the government balance. In the second wave, which followed liberalization of the financial markets, the private sector was in deficit, suggesting capital flows that allowed for credit expansion and GDP growth, and therefore a rise in imports.

La Marca showed the profile of the government balance and the impact of the interest payment profile. He also presented the sensitivity to income and real imports, which shows that the sensitivity has increased in the last years. This explains how imports soared with the growth of the economy during the last boom. The same can be said for the sensitivity of exports to real GDP in the EU. He noted that, during the crisis, the profit share increased and the wage share declined.

La Marca next provided an analysis of GDP by breaking down consumption, investment, exports, and imports. His analysis shows that the decline in GDP was mostly due to the decline of consumption, a drop in imports that was due primarily to the collapse in income, a miniscule increase in exports, and a decline in investment. He next examined productivity growth and employment trends by sector.

The model implements a multisectoral approach to better understand the macroeconomic forces at play. The model includes a social accounting matrix as part of the analysis of how the crisis unfolded. The model confirmed that the policy response to the crisis has reduced wages more than prices and export growth has been slight, which confirms the relative insensitivity of exports to price adjustment. The model was rerun using much more optimistic export elasticities to see if an export-led recovery is possible given current conditions in Greece.

La Marca reported real trade balance results for six sectors (agriculture, mining and quarrying, industry, tourism, transportation, and other services) before and after the shock hit the EU and the rest of the world. The model produced improvements in the trade balances largely through import contraction, not increased exports. He noted that even with far more favorable export elasticities consumption continued to collapse, employment did not rise, and value added did not increase. Based on these results, La Marca concluded that contractionary policies do not have a positive effect, even in the long run, on the contributions of exports to GDP. He argued that the missing element is investment.

Investment has not increased in response to current policies. Wage reductions have not led to lower prices. Without price reduction, and the resulting competitiveness, Greece cannot use exports to exit the crisis. Furthermore, austerity did not create the change in expectations—the market confidence that leads to rising investment. La Marca argued that investment, productivity, and economic growth cannot be rebuilt solely on the expectations of an improvement in the credit markets. Greece must promote a social dialogue among all of the stakeholders to create shared ownership of the problems and cultivate a better investment climate. This dialogue should occur in tandem with targeted policies to address the crisis.

ANTONOPOULOS observed that austerity has failed in Greece and Europe. Therefore, Greece must have an alternative strategy for growth. In the larger context of the European Union there have been many proposals for reform or to improve aspects of the economy. However, increasing employment and creating decent jobs are goals that are conspicuously absent from the current policy debate.

If the crisis and the policy response have taught us anything, said Antonopoulos, they have clearly shown the connection between economic policies and social policies. They cannot and must not be treated separately. It must be recognized that the policy of austerity, anticipated primary surpluses notwithstanding, includes a disastrous social dimension, the catastrophic consequences of which we have all witnessed. The lack of progress is visible in many of the most basic measures of economic activity in Greece.

Antonopoulos briefly reviewed government spending, disposable income, and consumption expenditures. All three measures have been declining during the crisis and show no sign of marked improvement. The most recent Bank of Greece data on major purchases, savings, and consumer sentiment show a continuing decline. The unemployment rate, which stood at 12 percent when the first Memorandum of Agreement was signed in 2010, is now over 27 percent and rising. In contrast, between 2008 and 2013, Germany was the only country in Europe that saw its unemployment rate decline.

Clearly, the critical question facing Greece is unemployment. Antonopoulos cautioned that while youth unemployment is important and has received widespread attention in the media, youth workers as a share of the total population of unemployed persons is relatively small. There are 1.3 million people in Greece who are unemployed. Of these, 173,000 are classified as youth. Unemployment policy must focus on the most vulnerable.

The employability of the Greek labor force has been cast as an explanation for unemployment. Antonopoulos finds little evidence for this explanation, noting that Greece has seen large numbers of skilled people leaving their home country for better labor markets. The supply of qualified labor is not the issue; it is the lack of demand for labor. Thus far, the private sector has not generated the necessary number of jobs, and there are no indications that it will be able to do so within the relevant time frame. Greece could respond by paying unemployment benefits or engaging in active labor market policies. Both of these strategies are essentially transfer policies. Or Greece could follow Minsky's suggestion: when the private sector cannot produce jobs, it is the responsibility of the state to provide jobs on a temporary basis, with government acting as the employer of last resort (ELR).

Antonopoulos explained that the ELR is not only an employment strategy. Ultimately, it is also a strategy for macroeconomic stabilization. The ELR recognizes that demand suffers as a consequence of job losses in a declining economy; businesses will not hire unless it is profitable to do so. In this context, the state is uniquely suited to hire workers countercyclically, and to a level that matches unemployment. The ELR also creates a floor for wages and worker rights. Finally, the ELR promotes the use of Greece's most important resource—labor—and produces socially meaningful output at the community level.

She next reviewed a Levy Institute proposal for an ELR for Greece that would create 550,000 jobs at a cost of 7 billion euros per year (and at a net cost of 3 billion euros annually). This cost includes the legal contributions, employer and employee contributions, and administrative costs; 40 percent of these costs are not wages but intermediate consumption for the materials needed to complete projects at the community level. Under the ELR, the 550,000 direct jobs created would generate an additional 155,000 jobs as a result of multiplier effects. The policy would also increase government revenue by close to 4 billion euros from direct and indirect taxes, yielding a net program cost of approximately 3 billion euros. (Financing of the ELR is addressed by Dimitri B. Papadimitriou on p. 74)

Antonopoulos concluded that Greece must address the central issue of creating employment opportunities for all who are willing and able to work. Employment must not be treated as a byproduct of policy but as a central goal of any recovery strategy. An ELR program is a modest and achievable goal for Greece. Given the scale and duration of the crisis, Greece should discard austerity in favor of policies that put people back to work.

KARAMESSINI addressed her comments to the role of employment policy in the Greek crisis. She characterized current policies as a test case for two assumptions of the dominant economic thinking: austerity can be expansive, and a 20–30 percent devaluation of wages and assets could generate export-led growth that would put Greece on the path to a sustainable recovery.

Both the scale of austerity and the scale of internal devaluation are huge by historical standards. She recalled that the Greek crisis has included a state-led recession, a 46 percent decline in investment, depression-level unemployment at 28 percent, a poverty rate of over 40 percent, and a decline in real wages of 22 percent between 2009 and 2013 (but no reduction in prices). Even with drastic austerity measures, internal devaluation has failed to create meaningful growth in exports. With mainstream economists continuing to claim that there is no alternative to austerity, Karamessini argued that it is the task of progressive social and political forces to create alternative policies. Further, she argued that the current recession has changed how we should understand the role of economic policy in crises as compared to ordinary times.

Labor market flexibility policies have played a direct role in the rise in unemployment. Unemployment benefits that normally act as economic stabilizers were cut and active labor market policies have adopted a defensive and passive posture. Under austerity, labor market deregulation has reduced labor costs as well as employee protections, and weakened the collective regulation of pay. In addition, reduced coverage agreements and the individualization of bargaining have directly impacted wages and labor costs. Finally, lowering of the minimum wage by 22 percent and 32 percent, respectively, for adults and youth had an enormous impact. Nominal wages fell by 20 percent between 2009 and 2013, and labor costs fell by 23 percent in the business sector. The result was that exports rose an anemic 6 percent during this period.

Karamessini noted that unemployment benefits in Greece have historically been a weak social shock absorber. Currently, Greece provides 18 percent of the unemployed population with benefits. This is because only 26 percent of the unemployed qualify for unemployment benefits: the long-term unemployed and the previously self-employed are not covered. She recalled that long-term unemployed workers represent 67 percent of the unemployed population, and thus represent an enormous number of people without benefits.

There were renewed, if modest, efforts in the second half of 2012 to implement community employment programs, with 55,000 beneficiaries. In 2013, new training programs were launched under the voucher system. Examining active labor market policies by type from 2009 to March 2012 shows that job maintenance programs represent the largest active labor market policy beneficiaries. She noted that these programs were implemented prior to lowering the minimum wage, which resulted in the mass subsidization of labor costs so that firms did not cut jobs in advance of the reduction in the minimum wage in March 2012. Between 2011 and the first quarter of 2012, 16 percent to 17 percent of all employees in the private sector were working in subsidized jobs. This had the direct effect of reducing dismissals. The other types of programs implemented include community employment programs to offset the reduction in jobs in municipalities.

Last, training vouchers are now the main component of employment policies in Greece. Trainees are often used as a low-cost substitute for hiring regular employees, especially in industries with high turnover. Overall, active labor market policies have been unable to counter the massive unemployment caused by the recession—or, more accurately, the wage-led economic depression.

Karamessini concluded that adjustment through the destruction of productive capacity is not economically or socially sustainable in any country. An alternative growth strategy is needed, one based on the redistribution of income domestically, restructuring of the sovereign debt, and securing investment from abroad. Employment policy would be better able to combat long-term unemployment and adapt the labor force to the needs of a new development model within the context of these kinds of strategies.

SESSION 6

Growth, Jobs, and Well-Being in Greece and Europe

Terrence McDonough, Louka Katseli, Nikos Xydakis, C. J. Polychroniou, David Stuckler

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MCDONOUGH emphasized that Ireland is not representative of how austerity works. Irish politicians have used the troika's requirements as cover for actions that they would have likely taken anyway. There is a widely held notion among politicians and the press that a capitalist economy tends to restore itself automatically to full-employment equilibrium. This approach defines policy success as meeting the targets and returning to the markets. If these are the criteria for success, then Ireland is the best in show among the PIGS (i.e., Portugal, Ireland, Greece, and Spain). However, the claims of economic success and the celebration of the return to Irish sovereignty are premature.

A broader examination of the state of the Irish economy should review the reduction of the fiscal deficit relative to the fiscal effort made by the government. The total fiscal adjustment has been close to 29 billion euros, or 17 percent of GDP, so far. Headline deficits over the same period have fallen by only 5.4 percent of GDP. In other words, Ireland spent 29 billion euros to achieve a drop of 5.4 percent. This figure actually falls to 4.6 percent if the effects of the banking crisis are stripped out.

These deficits are reflected in the expanding character of the government debt, observed McDonough. Ireland's public debt was low prior to the onset of the crisis and has now broken about 125 percent of GDP. This is partly due to declining GDP—a 9 percent drop from 2007 to 2010. In 2012, GDP remained more than 7 percent below its 2007 level.

The employment situation shows how the decline in economic activity has affected ordinary Irish citizens. The unemployment rate, including the underemployed, is about 25 percent. The unemployment figures would be higher if it were not for high levels of emigration. The combination of poor employment prospects and pressure on public sector wages has resulted in an overall decline since 2009 in average earnings and poverty rates have risen.

In terms of debt and finance, McDonough noted that Irish household debt as a percentage of disposable income was very low in 2003 at about 25 percent, and has risen rapidly to about 220 percent of disposable income. Housing prices have fallen about 50 percent from their peak, and about 65 percent of houses are underwater. Ireland has a rate of housing ownership above 80 percent, so when arrears hit about 25 percent of all mortgages this implies an incredibly large number of people. Credit advanced in the Irish private sector went negative in 2009 and has stayed negative, said McDonough.

What, then, are the prospects for the Irish economy? People have come to talk about the recession in terms of the shape of letters of the alphabet. A "V" is a sharp recovery and a "U" is a gradual reversal. At the moment, no analyst believes that Ireland is at the beginning of a U-shaped recovery. McDonough argued that we are in an economic crisis of historic proportions that is both structural and nested: the Irish crisis is nested within a European crisis, and the European crisis is nested within a crisis of global neoliberalism.

There have been historical precedents, including the long depression of the late 19th century, the Great Depression of the 1930s, and the Great Stagflation of the 1970s. McDonough argued that the cause of the long depression of the late 19th century was the crisis of competitive capitalism. The response was monopoly capitalism. The Great Depression was in its turn the crisis of monopoly capitalism, resolved by Keynesian capitalism. The Great Stagflation—the crisis of Keynesian capitalism—was resolved through global neoliberalism. The Great Recession, which we are now collectively facing, is best understood as a crisis of global neoliberalism. The response has been more global neoliberalism.

McDonough concluded that there is no evidence of recovery unless you assume that economies always expand after hitting bottom. There is also the possibility of an L-shaped recovery for both Ireland and Greece.

KATSELI proposed that Greece faces both a financial crisis and a moral crisis. She couched her argument in terms of three central themes. First, austerity policies have failed miserably in all countries and incurred high economic, social, and political costs. Second, the structural reforms are responsible for excesses beyond internal devaluation and for failing to reduce the debt. Third, there is a way out of the Greek crisis. She called for alternatives to current policies—Greece must undertake development reforms, and pro-growth reforms that support productive restructuring as part of a coherent policy to reduce the debt and sustain domestic purchasing power. To achieve these goals, Greece requires greater transparency, accountability, and breaking what he described as "the closed ring of power."

Reviewing the results of austerity since 2008, Katseli concluded that austerity has failed in every country where it has been implemented. Greece's public debt and unemployment rate are but two indicators of the damaging effects of austerity policies. Austerity has made all of these countries less competitive. Greek products, for example, have become less competitive in foreign markets despite reductions in employee compensation. This is because structural reforms have been accompanied by a large increase in indirect taxes, which is reflected in prices. Greece has also seen a decline in investment and productivity. She noted that the decline in productivity has been larger than the reduction in wages. Energy prices have increased, structural reforms have done nothing to open up markets or reduce rampant oligopolistic practices, and regulations have been used to protect entrenched interests. On these points, the International Monetary Fund (IMF) has been silent.

The IMF's recent evaluation does acknowledge that the policy of public sector involvement was expensive and delayed in its implementation. Katseli observed that the restructuring of the debt was delayed, and continues to be delayed, mainly because the big foreign banks—especially the German banks—need time to get rid of their bonds (i.e., Greek bonds). During this same period, new capital was given to the banks. The banks were permitted to write off their losses, but there was no discussion of offsetting losses to individuals or entities such as universities and hospitals. The debt burden has been shifted to European taxpayers.

Katseli argued that the response to the crisis has failed in part because the troika and the Greek government did not take into consideration the structure of production and employment in Greece. Almost 97 percent of the companies in Greece are small- and medium-size enterprises (SMEs). Between 2009 and 2012, the credit expansion to Greek SMEs was reduced by almost 18 percent and to households by about 11 percent. Resources were allocated to banks to assist SMEs, but the funds have not been disbursed. Again, said Katseli, the IMF has been silent on this point.

Finally, Greece has over indebted households. These loans have not been adequately restructured. The IMF evaluation does not address this issue, despite the 50 billion euro recapitalization of the Greek banking sector. One of the reasons why depreciation occurred over and above the initial fiscal contraction is the fact that the structure of the Greek economy and employment were not taken into consideration. Instead, the structural measures and reforms focus on fiscal targets or they serve specific interests.

Tax reform has increased income taxes, property taxes, indirect taxes, and selected retention of tax exemptions for selected groups, but there has been little progress in tackling tax avoidance and evasion or broadening the tax base. Labor market reforms, the dismantling of collective bargaining, deregulation of the labor market, reduced regulatory oversight, and basic worker rights are not also considered. Institutional reforms have largely reduced competition, not promoted it.

The solution, said Katseli, is an active investment policy and productive restructuring to lift Greece out of recession. This is possible if the government decides to renegotiate the debt and targets funds for the real economy. Greece must implement active labor policies and create a safety net for vulnerable groups. This is only possible if Greece can break the hold of entrenched interests. Katseli proposed several reforms: (1) restoration of the institutional reforms instituted in 2010 but later stopped, (2) tax reform, (3) reform of the justice system, (4) reform in governance, and (5) debt restructuring. And, Greece must reorganize the system of social transfers. Finally, Greece requires deep reform of its institutions to promote transparency and participation.

POLYCHRONIOU offered a thorough critique of the notion that economic recovery has taken root in Greece. The characterization of austerity as a "success" rests on the neoliberal troika, the complicity of elected leaders and the press, and bogus mainstream economics. He observed that mainstream economics guides the policies of the troika and the Greek government. For all its reliance on quantitative data, it has utterly failed to predict the processes it studies; notably, the global financial crisis of 2007–08. This, Polychroniou argued, is the result of ignoring political economy and relying on mathematical economics and econometric analysis. Mainstream economics has ignored the historical contributions of economists and social theorists alike. Mainstream economics mimics Newtonian physics while positing a view of capitalism as the path of endless progress toward the unlimited accumulation of wealth, aided by free market alchemy. We have seen countless financial and economic crises that have occurred since the ascendency of this dangerous neoliberal economic order, said Polychroniou.

The projections by the IMF are perhaps the best example of economic forecasting based on blind faith in neoliberal policies and free market dogma. In Polychroniou's view, IMF policies have one explicit goal: to roll back the average standard of living to create highly favorable conditions for international business investment opportunities and to increase the rate of profit for the corporate and financial elites at home. This, he said, is class warfare.

At the heart of the neoliberal vision, said Polychroniou, is a societal and world order based on the dominance of corporate power, free markets, and the abandonment of public services. The current version of neoliberalism was developed by Milton Friedman and the Chicago School, and implemented by Augusto Pinochet, Ronald Reagan, and Margaret Thatcher. It gained ascendency over Keynesianism in the 1970s and remains the most dangerous ideology of our time.

During the past several years Greece has served as a guinea pig for the policy prescriptions of a neoliberal European Union (EU) under the command of Germany and its northern allies, with the IMF serving as a junior partner. The EU has been the vehicle for imposing these policies on Greece.

Public debt has been used as an opportunity to dismantle Greece's economy and society. Today, Greece is a humanitarian crisis in the midst of one of the wealthiest regions of the world. Greece's output has experienced a cumulative decline of close to 25 percent, and the official unemployment rate has climbed to 28 percent.

The recent history of Greece speaks volumes about the economic damage and social pain that the neoliberal-oriented policymakers of the EU and the IMF delivered via the domestic political establishment. Comparable to Soviet communism, global neoliberalism has produced a dystopia that is causing increasing economic downturns and employment crises, financial shocks, poverty, and social exclusion.

The first bailout plan was a terrible plan—as bad as the Greek establishment itself, said Polychroniou. Austerity relied on a partnership between the troika and a group of political actors to implement its policies. The second bailout agreement was even harsher. Yet, to this day, EU and IMF officials remain committed to the policies that are responsible for the collapse of Greece. The IMF has three goals: pay back the loans no matter the cost to Greece, reduce the average standard of living, and strip Greece of her natural resource wealth.

Given their goals, it is easy to see why EU and IMF officials characterize the Greek crisis as a result of a bloated public sector. In reality, the problem was not the size of the Greek government but the lack of efficiency. The Greek political system played a role as well. The crisis is also the story of a kleptocratic state. Ultimately, said Polychroniou, the Greek economy did not belong in the eurozone and the EU, an elitist, highly undemocratic institution, needs to be revised.

STUCKLER addressed the connection between recessions, austerity, and public health. He noted the lack of awareness of the human health impacts of recession and austerity. There are clear correlations between economic hardship, unemployment, and depression. The countries that have implemented the deepest austerity measures have seen marked increases in suicides, heart attacks, alcohol-related deaths, HIV cases, and infectious diseases, to name only a few of the public health consequences.

Austerity has been a massive experiment on the people of Europe, said Stuckler. Social protections, from early childhood development programs straight through to old-age pensions, are a critical determinant of public health. He noted that nations that have done better in this recession, recovered faster, and improved their health typically have the strongest social safety nets. To test this hypothesis, he and his colleagues looked at different cases in Europe, including Greece.

Greece's health sector was given a target to maintain spending at 6 percent of GDP in order to meet budget deficit reduction targets set by the troika. It is unclear how this figure was determined, given that the UK spends about 10 percent and the United States about 19 percent of GDP. Greece's HIV prevention budget was cut in half and, as a result, Greece became the only nation in Europe, apart from Romania, to experience resurgence in HIV. Greece has also recorded its first outbreak of malaria since the 1970s. There has been a 60 percent rise in suicides, a 40 percent increase in infant mortality, and a 50 percent increase in people reporting that they are unable to access medically necessary care.

In contrast, Iceland, with total debt standing at 800 percent of GDP in 2008, faced bankruptcy, default, and economic hardship. However, when Iceland turned to the IMF for a bailout and was told to cut health spending by 30 percent, the public response was dramatic. More than 10 percent of the population protested in front of the Alþingishúsið, Iceland's parliament house. In 2010, 93 percent of Icelanders rejected bank bailouts and deep cuts in health and social protection spending. People did not lose access to health care in Iceland. There was no rise in depression or suicide. Once rated the world's happiest nation, Iceland, in 2011, in the middle of the worst banking crisis in history, was again rated one of the world's happiest nations.

Clearly, Greece and Iceland faced different circumstances. Iceland sits outside the eurozone and had the option to devalue its currency and boost exports. However, the contrast illustrates how an economic crisis need not lead to a public health disaster. Fiscal policy is literally a matter of life and death.

Some policymakers incorrectly assume that all government spending affects the economy equally. Using the IMF's own methods, Stuckler's group analyzed the components of government spending. They found that health, education, and social protection had some of the largest fiscal multipliers. In contrast, bailouts and defense spending in Europe were found to lead to trade deficits. This pattern is visible in the data: those countries that pursued greater government investment going into the recession have had faster recoveries. Greece made cuts and is recovering slowly, whereas the fastest-recovering economies (Finland, Sweden, and Germany) spent more.

Stuckler proposed policies based on three guiding principles: do no harm, treat unemployment like the pandemic it is, and invest in public health. The epidemics Greece is now confronting—HIV, TB, malaria, and drug resistance in hospitals—will cost far more to control than they would have cost to prevent.

SESSION 7

The Greek Experience of Austerity

Giorgos Argitis, Gennaro Zezza, Stavros Lygeros, Dimitri B. Papadimitriou

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Using Hyman Minsky's methodology as a guide, **ARGITIS** explained why the troika's policies were doomed to fail from the start. According to Minsky, the effectiveness of an economic policy depends on the extent to which it takes into consideration two points: (1) the particular institutional and structural aspects of an individual economy, and (2) the credibility of and correspondence between liquidity and debt obligations on the micro, medium, and macro levels. The policies in the troika's memoranda fully ignore these basic assumptions, and rely on a one-size-fits-all model for all economies.

First, Argitis analyzed two characteristics of the Greek model of capitalism: (1) the Greek economy is endogenously insufficient in creating sustainable rates of increase in national income, and (2) there is a systemic lag between income inflows and the government sector. The Greek economy has been a technologically weak, structurally noncompetitive productive system that has historically produced current account deficits and an increase in the external debt. Therefore, the Greek economy is highly dependent on spending, or demand-led growth. Changes in the redistribution of income, especially internal devaluation, have drastic effects on the economy. Also, the Greek economy tends to rely on imports because of the limitations of supply and its structurally noncompetitive productive base. The austerity programs imposed in Greece since 2010 ignore these endogenous features.

Another endogenous feature of the Greek economic model is that the prevailing business culture strives to achieve profits based on state-centered, parasitic, and redistributive activities (e.g., tax evasion and contributions evasion). Greek business culture in part explains why public revenues lag behind the economy. The basic consequence of these two features is that the Greek public sector is systematically unable to manage its credit risk and limited in its ability to meet its obligations.

Argitis suggested that Minsky would have concluded that the Greek economy had been sustained by a big state and a big central bank, but that after the country joined the Economic and Monetary Union, there was an institutional change: Greece became a big state without a big bank. This institutional change also made Greece very vulnerable by increasing its credit risk and weakening an important safety valve.

Greece's increased fragility was caused by the rise in financialization at the end of the 1990s and in the period of 2000–10. Households and enterprises dramatically increased their debt levels during this period. Financialization of the Greek economy was accompanied by a high rate of development resulting from expanded consumption, which in turn fed false expectations of creditworthiness and an ill-founded belief in Greece's ability to repay its public debt. Financialization created more pressure on the public deficit and debt. Argitis observed that catastrophe follows when austerity is imposed on an economy that relies on expenditures and has structural deficits in competitiveness, high private sector leverage, a fragile public sector in risk of default, and no central bank.

After 2009, fiscal austerity was implemented and there was an effort to restructure the debt. However, there was no change in the fragility of the Greek public sector because of the "Germanization" of debt management and austerity. Greece is experiencing income austerity, fiscal austerity, and deleveraging concurrently. Argitis suggested that austerity and the continuation of austerity would lead to the establishment of a laissez-faire model of a smaller state without a central bank. According to Minsky, this is an unstable model, prone to debt deflation.

In conclusion, Argitis argued that the lack of democratic legitimacy associated with austerity policies and the problem of national sovereignty argues for a rejection of the current path of national deconstruction. Toward this end, Greece must create the architecture of an alternative financial policy . Greece has much to learn from Minsky, and nothing to gain from the policies of the troika.

ZEZZA gave a general introduction to the methodology of the Levy Institute Model for Greece (LIMG). The model builds on the success of the Levy Institute model for the United States, which builds on the work of Distinguished Scholar Wynne Godley. Zezza offered a brief overview of the stock-flow consistent approach.

Stock-flow consistent models are characterized by no black holes (every debt is a credit for some other party); money flows imply stocks that feed back on your decisions in the future; and, finally, in a growing economy stocks and flows grow at the same rate, and should converge. This simple result can be used to test if the real economy is on an unsustainable path or not.

One of the main challenges of constructing a model for Greece was that the new data from the Atlantic Statistical Institute starts with the year 2000. The LIMG team reconstructed the data for earlier years using other sources. They found that the features of the Greek economy were not very different from other economies, including the United States. Basically, in the 1980s and early 1990s, private sector saving, in the aggregate, was sufficient to finance investment. The current account balance was fluctuating around zero, with a small deficit for Greece, and the counterpart to the excess of private sector saving over investment was the government deficit.

In Greece, as in many other countries, this more or less sustainable path started to shift in the 1990s, when private sector saving began to fall relative to investment, sometimes with the government deficit decreasing. The result was a deterioration of the current account balance. It is not clear which sector was driving the others. However, stated Zezza, we can say that the sources of instability in Greece can be traced back to the 1990s. The government deficit in 2008 was not very high compared to historical levels and was not the cause of the crisis. The principal factor appears to have been the large foreign imbalance, which implied significant foreign debt.

Beginning in 2001, most of the public debt was held by Greek residents. Over time, the share of debt held by foreigners increased because of the current account imbalance. Also, starting with the crisis in 2008, the general government debt, in the form of securities held by foreigners, was very high, and was quickly liquidated and transformed into long-term loans. As a result, the majority of government public debt became long-term loans from abroad, held by eurozone institutions, and a small percentage of short-term loans from domestic banks. Zezza next discussed a possible agenda behind the troika's actions. In the early stages of the crisis, the eurozone did not suspend the treaties, provide Greece with additional financing, and avoid austerity. Likewise, Greece, in the absence of assistance, could have redenominated its debt in a new currency. Under this scenario, in 2008 the German banks, French banks, Italian banks, and so on would have suffered the loss resulting from the eventual devaluation of the new currency, and the Greek economy would have had to deal with the challenges of exiting the euro; but it could have done so. Instead, the debt was restructured in such a way that none of the foreign exposure of the Greek government was under Greek legislative control. Should Greece decide today to exit the euro, it could not redenominate its debt in a new currency. Greece can either default on the debt or keep paying. If this was one of the goals of the bailouts, said Zezza, it has been achieved.

He next reviewed some of the LIMG results, which show that both exports and imports of goods have high income elasticity and low price elasticity. Therefore, during a recession, the trade balance will improve because imports will fall very fast. However, a policy that tries to address current account problems through price competitiveness will take a long time to produce results. The situation worsens further if internal devaluation is applied. Zezza left further description of the LIMG results to the next speaker, Dimitri B. Papadimitriou.

PAPADIMITRIOU, paraphrasing Godley, emphasized that scenarios are not forecasts. They are simulations based on assumptions. His remarks included an overview of the evolution of the Greek crisis and current conditions, the development of the LIMG, and a detailed discussion of the scenarios and policy options to facilitate an exit from the crisis.

Papadimitriou offered a comparison between the conditions in Greece and the Great Depression in the United States to highlight the severity of the Greek crisis. He noted that the United States began growing by the fourth year of the Great Depression. This is not the case for Greece, which by 2013—five years into the crisis—had lost 23 percent of GDP. Despite the ongoing crisis, the troika's strategy remains one of fiscal austerity, reducing public employment, increasing taxes, and privatizing public enterprises, with an internal devaluation target of 15 percent. Papadimitriou next provided a brief overview of the components of aggregate demand as context for the results of the LIMG simulations.

The LIMG baseline projection assumes that austerity will continue as required by the troika, but no additional austerity will be implemented. Papadimitriou noted that, thus far, the troika's actual results have consistently been far worse than its projections. In contrast, the LIMG model shows a close correspondence to actual events. Under the austerity simulation, the LIMG model yields a growth rate of 34 percent unemployment by 2016, while the troika projects an unemployment rate of approximately 24 percent by 2016. He also presented three indices that use consumer prices, GDP deflation, and unit labor costs. He noted that Greece has made some progress in terms of the unit labor cost, but not in terms of prices. In addition, export-led growth is not growing in line with the expectations of troika.

The first policy scenario outlines a Marshall-type plan for Greece. The plan would be overseen by the European Investment Bank or another European Union institution. Outside oversight is intended to quell concerns about improper implementation of the plan. The total cost is estimated at 30 billion euros, or 2.5 billion euros per quarter beginning in 2014 and extending through 2016. The plan has direct job creation as its central feature.

Papadimitriou presented a comparison of several scenarios: the Marshall Plan scenario, and the troika's GDP target and debt target scenarios. The troika suggests that if the austerity measures are applied, Greece will meet its GDP and deficit reduction targets. He cautioned that these targets are inherently incompatible. Greece can either reduce its debt or increase GDP, but it cannot do both. In terms of employment, the troika scenarios are similarly incompatible. In contrast, the modified Marshall Plan would create approximately 200,000 new jobs by the end of 2016, whereas the troika's scenarios for the government deficit would require additional austerity to reach its goals.

Papadimitriou next discussed the results of the simulation of a second policy option, which assumes that Greece suspends all interest payments and therefore freezes the public debt. Under this plan, Greece would not pay interest until GDP returned to 2010 levels. This would involve an agreement with Greece's creditors to roll over all maturing debt until that goal was reached. The scenario assumes that total annual interest payments are 7.5 billion euros per year. The assumption is that this amount would instead be used for public consumption, targeted investments, or financing a direct job creation program. Overall, the Marshall Plan scenario performs somewhat better than the debt-freeze scenario.

Under the Marshall Plan scenario, 200,000 jobs resulting from targeted investments would be created by 2016, whereas the direct job creation proposal would create closer to 700,000 jobs for the same amount of money. However, if Greece lacked the political will to adopt the job creation strategy, it could consider alternatives to exiting the euro. One option is to create a parallel financial system.

In this scenario, the Bank of Greece would be responsible for the currency, to avoid government exceeding the agreed-upon limits. Instead of currency, said Papadimitriou, the Levy Institute proposes using perpetual bonds, or "Geuros," as described in a Deutsche Bank report on parallel accounts. These bonds would be used for several purposes, but specifically for tax payments. The bond would have one-way convertibility (euro to Geuro, but not vice versa). The impacts of a parallel currency are not very large if it is only used for debt reduction. Based on the LIMG simulations, the Institute recommends a combination of the parallel currency proposal and the direct job creation and debt freeze scenarios for maximum effect.

SESSION 8

Rethinking Europe's Future

Yannis Dragasakis, Loukas Tsoukalis, Alexis Papahelas, Martin Hellwig, Kerstin Bernoth

MODERATOR:
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Kathimerini

KERSTIN BERNOTH
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LOUKAS TSOUKALIS
University of Athens; King's College, London; and ELIAMEP

YANNIS DRAGASAKIS
Hellenic Parliament

The eurozone needs alternative shock absorption instruments to respond to asymmetric business cycle shocks and reduce the tendency to economic divergence. **BERNOTH** proposed the creation of a European cyclical transfer mechanism to promote stability to the European Union (EU) in the medium and long run. Her proposal addresses some of the Economic and Monetary Union's (EMU) unique characteristics. Namely, EMU member-states have committed to a common monetary policy while fiscal policy remains completely the responsibility of the individual governments. Bernoth noted that the EMU marks the first time that such a high degree of monetary integration has been attempted without fiscal or political centralization. As a result, it is limited in its ability to use monetary and exchange rate policy as a stabilization tool to counter asymmetric shocks. Business-cycle divergence is also amplified under the current structure. While the European Central Bank (ECB) targets average inflation and economic development for the whole euro area, its monetary policy will never be optimal for all countries and thus can create greater divergence.

National fiscal policy typically plays a role in moderating shocks and cycles. Governments follow a countercyclical fiscal policy to stabilize a country's economic fluctuations by collecting surpluses in booms and incurring deficits during recessions. Bernoth observed that national fiscal policy has not provided the necessary degree of stabilization in recent years. As a result, some countries have a huge bulk of government debt. Greece is currently required to operate under a procyclical fiscal stance that does not dampen the business cycle but rather amplifies the recession. An international insurance system to counter asymmetric cyclical income fluctuation is one option for creating a stabilization mechanism, but, Bernoth cautioned, we must avoid describing it as a "transfer mechanism."

The basic idea of that system is that, if a country is in a favorable cyclical economic situation compared to the average of the euro area, it will pay into the compensation scheme, and, if a country is in an unfavorable cyclical position, it will actually be a net receiver of payments. Bernoth stressed that the goal of such a system is not to achieve balance of income or to balance the living standards of member countries. The goal is to mitigate business cycles—the same role played by national monetary policy or exchange rate policy in the past. A recent study of a cyclical transfer mechanism using a dynamic general equilibrium model found that it is comparable to national monetary policy in mitigating asymmetric business cycle shocks. She noted that federal systems of government, such as the US, typically have of cross-country insurance scheme but the EU does not yet have such as system.

Bernoth next outlined the characteristics of a viable cyclical insurance scheme: (1) payments should be transferred quickly and on time to serve their countercyclical stabilizing and synchronizing purposes; (2) the payment mechanism should be governed by rules to prevent arbitrary political decisions and to increase transparency; (3) the compensatory mechanism should be oriented toward cyclical fluctuations, so as not to structure differences or structure growth differences among member countries; (4) the transfer mechanism should be accompanied by strong fiscal rules; and (5) participation in the compensation system should be subject to conditions such as structural reforms as an incentive mechanism.

There are a number of ways in which such a system could be implemented—for example, as a direct fiscal transfer payment system or as an indirect transfer mechanism through a European unemployment insurance scheme parallel with national insurance systems. A European unemployment insurance system has the advantages of being relatively quick to respond to the business cycle, less room for arbitrary political manipulation, direct impact on aggregate demand through private households, and ease of administration.

Bernoth stressed that an international insurance mechanism, or compensatory payment mechanism, cannot replace sound economic and fiscal policy. This mechanism will not be enough actually to synchronize the business cycles in the EMU. National countercyclical fiscal policy will also be needed. Finally, participation in the mechanism might be contingent on labor market reforms and compliance with fiscal policy rules to reduce the potential for distortion.

HELLWIG opened with the question, what would have happened if in early 2010 the European institutions had told Greece to resolve its problems with the banks on its own? The immediate economic impact would have been sharper because the net flow of money to the Greek government would have stopped. But we would not have heard the word "troika" over the course of this conference, said Hellwig, and the banks would have suffered. The reason for the current muddle is that the banking problems have not been solved. The "banking problem" is not limited to the Greek banks implicated by Greek sovereign debt, or the problem of Spanish and Irish banks implicated by a real estate bubble. The banking problem includes French and German banks that are weakly capitalized and have not been cleaned up since the crisis. The problem is the complexity of sovereign debt, real estate bubble exposure, and weakly capitalized banks holding bad debt leading to crises that are interconnected through the euro system that has made for the muddle.

Europe is a symbiosis of sovereigns and banks in a supranational monetary system. Many of the shocks that have been identified are not shocks in the macroeconomy but shocks that proceed from problems of governance and systematic effects that extend over the longer run. There is a connection between supervision, politics, and banks when it comes to government funding, and a connection between supervision, politics, real estate, and banks when it comes to dealing with local and national interests, especially in the real estate sector. This can be said about every country in the eurozone, including Germany.

Any viable system of governance needs some element of discipline for people who borrow and for people who lend, observed Hellwig. The euro system destroyed important elements of discipline; in particular, market discipline. The lack of national exchange rates removed a valuable signal that alerted the media and the domestic polity to important changes in the economy, particularly government debt. In addition, Europe has nonintegrated goods markets and nonintegrated markets for many services, which allows for different inflation rates, which in turn creates significant potential for bubbles. Countries on the periphery with significant price increases had low real rates of interest, and that fostered borrowing.

Creditors did not impose risk premiums. This was a lack of market discipline on the side of creditors. It is difficult to know why there was so little market discipline by creditors, said Hellwig, but the lack of budget discipline and the lack of market discipline are central to the problem. This, in turn, was enabled by a lack of supervision.

Today, we have an enormous amount of indebtedness, unresolved problems, and nonperforming loans. In short, Europe has a lot of financial skeletons in its closet. If nothing happens, "muddling through" will yield 20 years of what the Japanese experienced, except that Europe tends to be less patient than the Japanese and much more prone to conflict.

The relation between sovereigns and banks, and the symbiosis between the two, explain the need for a banking union, though Hellwig expressed doubts about its prospects because of ongoing political resistance. For example, the current regulation that created the single supervisory mechanism gives the ECB the power to apply all union law. In the case of directives that are not applicable, the ECB is supposed to apply the national laws that implement the directives. How would this work? There are 16-plus jurisdictions with different court systems, with different national laws, in a single supervisory mechanism. Likewise, the system requires a resolution mechanism and a fiscal backstop. The current European Stability Mechanism is too small for this task.

Hellwig concluded that Europe must move forward with the banking union because the alternative is a breakup that would create bank runs and extraordinary turbulence. A previous speaker proposed the creation of an alternative currency, but Hellwig suggested that any hint of a serious possibility of an alternative currency would be followed swiftly by an exit.

TSOUKALIS observed that the current crisis in Europe is the worst crisis since 1929, and the worst crisis since the beginning of European unification. There are three dimensions to the crisis: international (i.e., the result of a bubble in the Western economies), European (currency integration without the tools to defend a currency during a crisis), and national (the economic and political weaknesses of individual European countries).

Five years following the start of the crisis Europe seems to have avoided the worst by doing things that were unthinkable prior to 2009—for example, the bailout of individual European countries, restructuring Greek sovereign debt, massive interventions by the ECB, fiscal policy and general economic policy coordination, and so on. All of these actions occurred at the 11th hour, and only the absolute minimum was done. Consequently, these actions were never enough, either in the political sphere or in the marketplace. And Europe allowed the burden of adjustment to fall mainly, if not exclusively, on the weaker, debtor countries. Tsoukalis noted that an interesting division of labor has emerged: the debtor countries have undertaken the main burden of adjustment, but the creditor countries have undertaken the credit risk and will not be paid back if the debtor countries do not recover.

Europe took this approach for several reasons. First, this is the way European institutions work. Second, the cost of adjustment is huge, and Europe could not agree on who should foot the bill. Third, the economic crisis led to more economic divergence within the EU. For example, the way the crisis has been experienced in Germany is very different from the way it has been experienced in Ireland, in Portugal, in Spain, or in Greece. This divergence, combined with the rising populism and nationalism in individual European countries, makes it very difficult to find solutions for Europe's common problems.

The price Europe has paid for muddling through and short-termism is a higher, more painful adjustment cost than anticipated, and over a longer period of time. Today, the most optimistic scenario for the average European country—not Greece—is that it will return to 2007 living standards by 2016. Europe will have lost a decade of growth. Unemployment is 12 percent on average in the eurozone, and in some countries has reached levels that were formerly unimaginable for peacetime. Many banks in Europe remain undercapitalized, and there is also a huge debt overhang, both private and public. Yet, muddling through is likely to continue as the preferred strategy in the months and years ahead.

In the next few months there may be an effort to implement a banking union, but it is likely to ignore many of the problems of the banks. Europe will not address the legacy problem (i.e., the accumulated debts of individual banks) or the unsustainability of much of the private and public debt. Instead, Europe will continue to wait for robust growth—but growth will not come. The result will be anemic and uneven economic growth in Europe. Much of the periphery will continue to languish, with zero growth and very high rates of unemployment, leading to a divided and inward-looking Europe. But the muddling-through strategy will continue as long as there are enough people in individual European countries who believe, perhaps rightly so, that the alternative is worse.

Tsoukalis observed that the strategy of muddling through is vulnerable to shocks from markets and from politics. Political extremism is on the rise in many European countries. The alternative to muddling through requires a European grand bargain that may include greater macroeconomic flexibility, and more growth measures coupled with important structural reforms. Flexibility from the North must be balanced with reform in the South. This is the crucial challenge facing Europe today, said Tsoukalis, and it is unclear if Europe will rise to meet it. In conclusion, he warned that the alternatives to a breakup of the EU would be worse: they would be disastrous.

DRAGASAKIS stated that policy alternatives are not enough: Greece needs a strategic plan to take it from destruction to a creative reconstruction of Greek society. He noted that currently, any discussion of alternative policies is taboo in the Hellenic Parliament. The government will not entertain any proposals other than those policies articulated in the troika's memoranda. Dragasakis stated emphatically that Greece needs more than alternatives. He noted that the present lack of political will for a Marshall-type plan for reconstruction of Greece's economy and society remains an obstacle to recovery. He addressed the balance of his remarks to the issues and proposals raised during the conference.

The euro can be sustained, but it is a question of under what conditions it will continue. The current imbalances make it difficult to predict what will happen. Strong economies might opt out of the euro, while weaker countries might exit the euro as a response to economic distress. Today, Dragasakis commented, the original vision of the euro has turned into a nightmare for many. In terms of democracy, the eurozone institutions seem to be out of touch with the lives of many Europeans. Reforms are needed to enhance participation and avoid a loss of legitimacy.

There are at least three versions of the European Union. There is the neoliberal, market-based version of the euro, which includes scant provisions for dealing with a crisis. This form lacks democratic institutions and cannot survive in its current form. There is also the Keynesian version of Europe, based on the free movement of capital and markets. This version, if adopted, would include such things as fiscal transfers, deposit guarantees, and recycling surpluses, is closer to the ideas of the Left and has the potential to moderate many of the excesses experienced in the current crisis. However, the Keynesian version would not address the root causes of economic bubbles caused by free capital movement, nor does it include an explicit treatment of the social and political institutions needed. The third version is that of the Left. SYRIZA supports a version of Europe that is based on progressive ideas and builds on social movements.

Dragasakis discussed the US response to the crisis and what, if any, lessons might be gleaned from it. He cautioned that the European project was, at its founding, intended to be a new international paradigm. Europe must strive to develop its own model. He closed his presentation with his reflections on the policy alternatives discussed by Papadimitriou in the previous session.

Greece requires not one but all of the proposals discussed in the LIMG scenarios. It needs a Marshall-type plan for reconstruction, a moratorium on debt payments, and alternative means of creating liquidity, including but not limited to a parallel financial system. Also, given the economic and social conditions in Greece, the country will require regulatory exemptions until it recovers. Dragasakis expressed his concern that the recession in Greece may not be over. Greece too often lacks accurate information about, for example, the current level of unemployment. Thus, it is prudent to consider the widest range of recovery options. In conclusion, he noted that Greece's best hope of emerging from the crisis is an integrated reconstruction plan within a reformed institutional framework.

Participants

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