THE AUSTRALIAN

Greek drama could unleash the furies

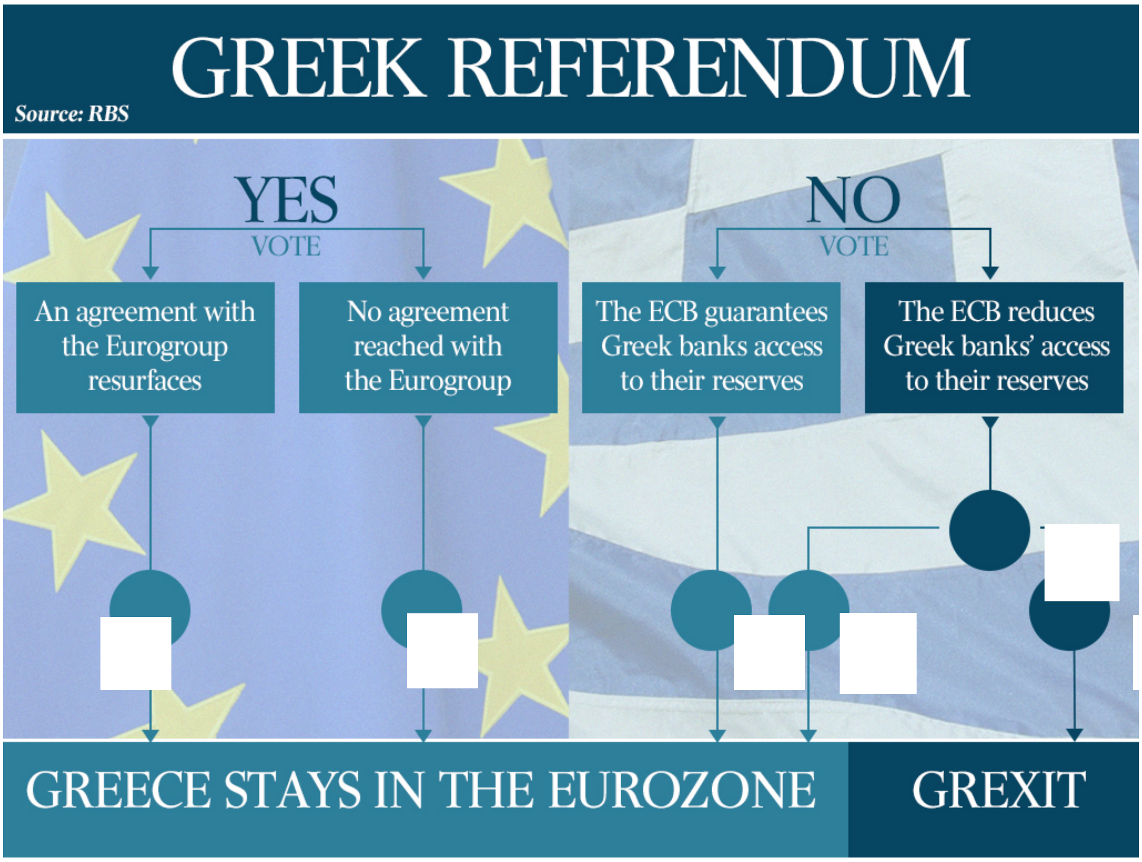
HENRY ERGAS THE AUSTRALIAN JULY 04, 2015 12:00AM

Pensioners line up outside a National Bank branch in Athens, Greece. Source: Getty Images

Like every great tragedy, it is all about fate, but fate in the sense of the Greek word ananke, a force even more powerful and pitiless than the gods. Yet as the referendum that will decide Greece's future looms, any ultimate resolution of the euro's drama seems as remote and uncertain as ever.

One thing, however, is clear: the European project, with its promise of an "ever closer union" that would stretch from Lisbon to Helsinki, lies shattered on the rocks of unrealistic expectations. And as that project's flaws continue to play themselves out, the costs will only mount.

To say that is not to suggest a Greek exit from the euro would destroy the single currency: it wouldn't. Nor would Greece leaving the euro trigger a broader European collapse: with official creditors now holding almost all of Greece's sovereign debt, the exposure of Europe's financial system to developments in Greece is readily manageable.



As for the possibility of panicked investors sending interest rates spiralling on the sovereign debt of other heavily indebted eurozone countries, the European Central Bank has all the firepower it needs to stabilise markets, including by simply buying those countries' bonds.

But it would be foolish to underestimate the harm Greece's unfolding drama has caused the EU, not least by undermining public confidence in its institutions. And though the FTSE 100 and the Deutsche Borse DAX index are still above their levels at the start of the year, the sheer difficulty of predicting the consequences of a Greek exit would add to fears in jittery sharemarkets, dampening an already weak European recovery.

All that pales, however, compared with the wreckage that would fall on Greece as the country faces a crisis of existential proportions. At the sharp end of that crisis is the financial chaos that would envelop the Greek economy were Greece to leave the euro. With a private sector that holds substantial euro-denominated debt, and a banking system whose capital and foreign exchanges reserves are largely depleted, the move to a new, sharply devalued, currency risks triggering a wave of bankruptcies.

Since the government's default, and its refusal to accept the conditions lenders have imposed, would prevent the EU and the International Monetary Fund from assisting Greece, the country could experience a further, even more catastrophic, decline in output and employment. Given a volatile and deeply divided Greek electorate, the result could be a prolonged period of political turmoil and economic collapse.

But the longer-term consequences would be every bit as material. As two of the leading scholars of modern Greece, Mark Mazower and Stathis Kalyvas, have argued, the recurring pattern in the country's history, from its 1821 war of independence on, has been one in which Greece periodically attempts more than it can achieve, only to be rescued through the intervention of friendly powers.

Independence itself, for example, was secured only thanks to France, Britain and Russia, whose navies destroyed the Turkish and Egyptian fleet at the battle of the Bay of Navarino in 1827.

Equally, it was the European powers who salvaged Greece after it was defeated by Turkey in the war of 1897, and stabilised its finances in the tumultuous decades that preceded and followed that rout.

As for the no less disastrous Greek invasion of Turkey in 1921, it was an international humanitarian effort — arguably, the first of its kind — that allowed the country to smoothly absorb the 1.3 million refugees forced out of Turkey in its wake.

And it was international intervention, led by Britain and the US, that defeated the communist insurrection in the savage civil war of 1944-48, and ensured, as the war ended, that Greece's economy got back on its feet.

Little wonder then that Greece looked to Europe when the military junta, which controlled the country from 1967 to 1974, collapsed after an ill-judged attempt to impose union on Cyprus.

Faced with a domestic and international backlash, Konstantinos Karamanlis, the great Greek statesman who was called on to clean up the mess, sought to entrench the liberal democratic institutions he was putting in place by bringing Greece into what was then the European Economic Community.

Karamanlis saw the EEC's emphasis on binding rules, along with powerful supra-national enforcement mechanisms such as the European Court of Justice, as imposing vital constraints on a nation that constantly failed to reconcile aspirations with realities. Greece's accession in 1981, which made it the first country of the European periphery to join the EEC, not only signalled its anchoring in what was perceived as modernity, but was also viewed as reaffirming the European powers' willingness to acknowledge Greece's special importance, including through generous financial support.

It was in much the same spirit that Greece sought entry into the euro. As finance minister, Kostas Simitis had tried but failed to curb the worst excesses of Andreas Papandreou's socialist government in the run-up to the 1989 elections. When he became prime minister in 1996, Simitis made adoption of the euro a priority.

Simitis was not just seeking the benefits that would come from vesting control over monetary policy in the ECB, which was regarded as a supra-national version of Germany's legendary Bundesbank; rather, the euro, and the fiscal commitments on which it was based, were portrayed, at least in the economic policy debates, as a way of strapping Greece to the mast of fiscal and monetary rectitude.

But Simitis's decision was a fatal miscalculation. Far from mimicking cautious Ulysses's ploy for safely sailing past the sirens' call, Greece's entry into the euro smacked of the hubris of Icarus, soaring towards the sun without any precautions against a fall. And while Simitis had made progress in balancing the books, much of the consolidation was achieved by concealing liabilities rather than by addressing the crippling burdens the government of Papandreou had left behind.

Until that government, and even more so before the coup of 1967, Greece had a small public sector, with welfare benefits that were meagre by European standards. Papandreou, the first Greek politician of the television age, transformed it, bestowing benefits on new constituencies, while also encouraging those constituencies to organise themselves into lobby groups he could affiliate with his Pan-Hellenic Socialist Movement (PASOK).

One of Papandreou's earliest and proudest achievements, for example, was Law 1285 of 1982, which not only extended full pension entitlements to 400,000 people who had (or claimed to have) fought with the communist-aligned EAM/ELAS in the resistance and civil war, but accorded privileges to their descendants.

Decisions such as these helped double the ratio of public spending to GDP while pushing public debt from 28 per cent of GDP in 1979 to 120 per cent in 1990.

But Papandreou's legacy was far worse than that. Although Greece had never had an efficient public administration, much less one free of corruption, the small size of the state limited the harm that caused. But Papandreou used the greatly expanded public sector as a source of patronage, eliminating the however thin layer of reasonably neutral, technical experts Greece once had. Instead, already by 1984, it was estimated that close to 90 per cent of PASOK's card-carrying members had some form of paying connection to the public sector, while corruption had reached epidemic proportions.

Those flaws were never corrected, as successive governments added more beneficiaries to the vast numbers their predecessors had graced. Indeed, Simitis himself vigorously resisted measures to curb patronage and corruption, most notably in the preparation for the 2004 Athens Olympics.

Greece therefore went into the euro with a bloated public sector, chronically loss-making government enterprises, persistently high public debt, and an inept, often venal, administrative and political class, along with some of the best-organised claimants' lobbies in Europe. More than any other euro country, it was vulnerable to adverse shocks, and very poorly placed to absorb them on its own.

The eurozone, however, was never meant to be a transfer union: that is, an economic unit in which shocks are cushioned by transfers from better-off countries to those that are struggling. All the initial plans for European monetary unification had emphasised the need to parallel a single currency with fiscal mechanisms that would help countries cope should shocks occur; but when the euro was being negotiated, it was apparent that any structure that made Germany and its northern neighbours responsible for the weaker economies' debts was unacceptable.

As a result, the 1993 Maastricht Treaty, along with the 2007 Treaty of Lisbon, which define the legal basis for the single currency, contain prohibitions that prevent bailouts and preclude the ECB from "monetising" member states' debt. Instead, resilience was to be achieved by rules, initially set out in the Stability and Growth Pact, which limited deficits and debt accumulation, thereby ensuring each member state retained enough fiscal room to ride out downturns through temporary resort to deficit spending.

But that pact lacked credibility, not least because — as the ECB's former chief economist, Otmar Issing, once said — its enforcement relied on potential sinners passing judgment on actual sinners. That much was apparent in 2003, when the European Commission proposed opening infringement procedures against France and Germany; but the Council of Economic and Finance Ministers, meeting under its Italian president, rejected the proposal, in a decision the European Court of Justice upheld, despite the obvious fact the pact had been breached.

Little wonder Greece largely ignored the pact, including by fudging its fiscal reporting, with the European commissioner for trade, Karel de Gucht, telling Spain's El Pais in May 2010 that "we knew Greece was cheating, it was clear as soon as they joined (the euro)".

Yet even had the pact been more constraining, its targets would have been of no relevance to Greece when the crisis struck at the end of 2009, by which time public debt stood at 130 per cent of GDP. At that point, the EU was caught in a dilemma: it could take the "no bailouts" provisions seriously, risking a firestorm across southern Europe; or devise ways of assisting Greece while respecting the plain language of its treaties.

Unsurprisingly, the result was widespread confusion. On the one hand, French president Nicolas Sarkozy told reporters the EU was ready to help Greece "at any moment"; on the other, German Chancellor Angela Merkel insisted the eurozone was bound by a treaty "under which there is no possibility of (Germany) paying to bail out states in difficulty".

No one could commend the process that led from that confusion to the successive rescue packages, beginning with the agreement reached on May 2, 2010. Nor could anyone deny the extent of the suffering in Greece, where the contraction now far exceeds that the US experienced in the Depression.

But it is also important to recognise that assistance to Greece has been lavish compared with that generally provided to countries in similar difficulties. During the Latin American debt crisis, for example, IMF support to affected countries averaged 76 per cent of their IMF "quotas", which reflect a country's maximum financial commitment to the fund; equally, when the countries of eastern Europe managed the wrenching transition from communism, the IMF loans they received averaged 43 per cent of their quotas. In contrast, Greece has been granted loans amounting to an extraordinary 1860 per cent of its quota.

Moreover, effective interest rates on Greece's outstanding loans are now extremely low, with interest payments (on what is close to 180 per cent of its GDP) amounting to as little as 2.6 per cent of GDP.

Greece's complaints are therefore exaggerated. In essence, they amount to the demand that Greece should, once again, be treated differently, including by having other European taxpayers, many on incomes lower than those in Greece, shoulder the costs of forgiving Greek debt. With Prime Minister Alexis Tsipras, who leads a party of the extreme left, clumsily prosecuting that claim, it is hardly puzzling that his European counterparts have finally had enough.

Whether that ends Greece's special relationship with the European powers remains to be seen. If the Greeks vote no, Greece, for the first time in the modern era, would be truly on its own; with all the dislocation that involves, it could be many years before even the flicker of a recovery emerges.

That is not to ignore the hardship a yes vote, and the resulting acceptance of the proposed package (assuming it remains unchanged), would also entail. Yet there is every reason to think it could help set the foundations for an eventual return to growth.

Greek voters might learn a lot from the Balkan neighbours they have always despised. They too underwent harsh adjustment programs, marred at times by deep conflicts with the IMF; but once far-reaching domestic reforms had been carried out, the gains proved material and sustained.

Bulgaria's per capita income, for example, was barely a quarter to a third of Greece's when communism fell; now, after the market-oriented changes made under finance minister Simeon Djankov, it is 70 per cent of that in Greece, despite Bulgaria having a currency board that is required to keep its exchange rate pegged to the euro.

There is no reason whatsoever Greece could not match that performance. After all, from 1961 to 1973, the Greek economy grew at a spectacular annual rate of 7.4 per cent, thanks to fiscal prudence, monetary restraint and wage moderation; with ample underused resources and plenty of scope to increase efficiency, it should be able to return to the expansion Greeks once took for granted.

But that outcome will not fall from the skies; it requires reforms the Greek electorate has consistently rejected. There is a real risk that come Sunday, the Greeks, instead of peace, may find they have unleashed the furies.

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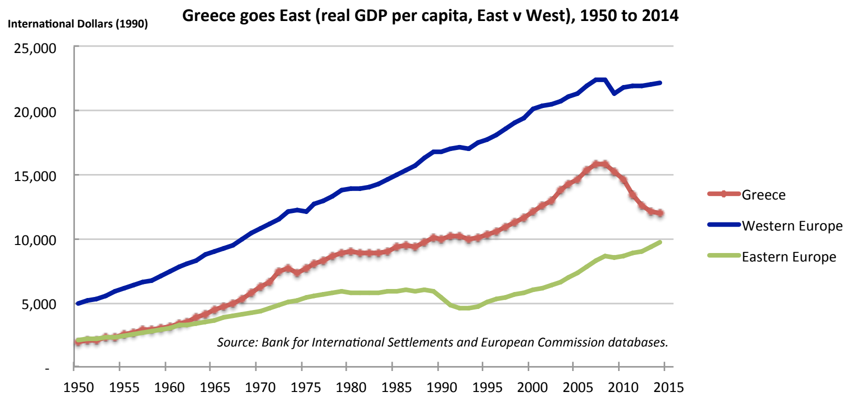
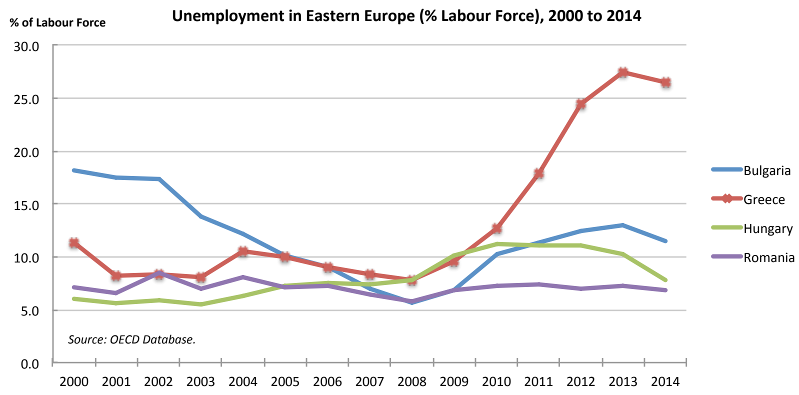
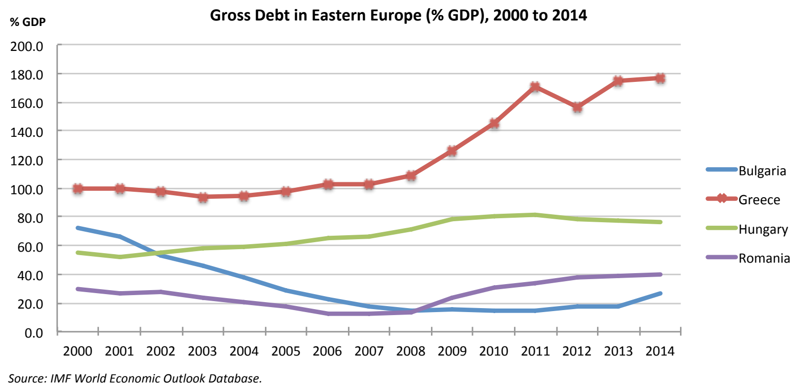
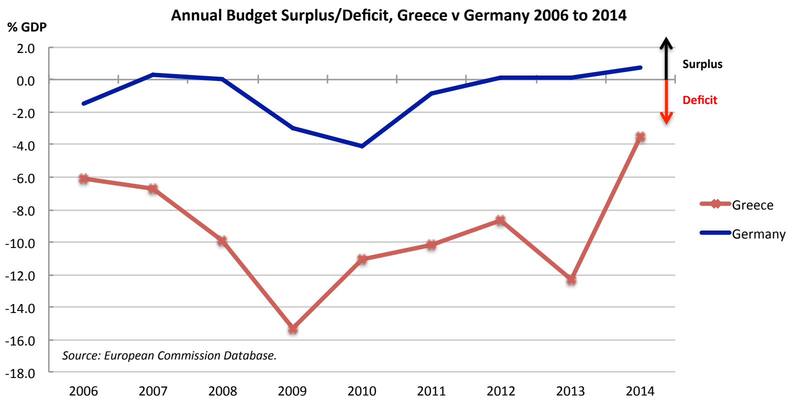

Greece goes East (real GDP per capita, East v West), 1950 to 2014
International Dollars (1990)
25,000
20,000
15,000
10,000
5,000
-
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Greece
Western Europe
Eastern Europe
Source: Bank for International Settlements and European Commission databases.


Unemployment in Eastern Europe (% Labour Force), 2000 to 2014
% of Labour Force
30.0
25.0
20.0
15.0
10.0
5.0
0.0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Bulgaria
Greece
Hungary
Romania
Source: OECD Database.


Gross Debt in Eastern Europe (% GDP), 2000 to 2014
% GDP
200.0
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Bulgaria
Greece
Hungary
Romania
Source: IMF World Economic Outlook Database.


Annual Budget Surplus/Deficit, Greece v Germany 2006 to 2014
% GDP
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
-14.0
-16.0
-18.0
2006
2007
2008
2009
2010
2011
2012
2013
2014
Surplus
Deficit
Greece
Germany
Source: European Commission Database.