ΕΛΙΑΜΕΠ ELIAMEP
ΕΛΛΗΝΙΚΟ ΙΔΡΥΜΑ ΕΥΡΩΠΑΪΚΗΣ & ΕΞΩΤΕΡΙΚΗΣ ΠΟΛΙΤΙΚΗΣ
HELLENIC FOUNDATION FOR EUROPEAN & FOREIGN POLICY

It's Time for a New Deal

by Constantine Michalopoulos
Senior Policy Advisor

January 2020

Policy Brief No. 61/2020

HELLENIC FOUNDATION FOR EUROPEAN AND FOREIGN POLICY
49, Vas. Sofias Avenue, 10676, Athens Greece
Tel. +30 210 7257 110, Fax +30 210 7257 114, E-mail eliamep@eliamep.gr, www.eliamep.eu

It's Time for a New Deal

by Dr Constantine Michalopoulos

Constantine (Costas) Michalopoulos has worked on and written about economic development and poverty eradication for more than half a century. Most recently he has been Visiting Scholar and Adjunct Professor of Economics at the School of Advanced International Studies of Johns Hopkins University in Washington DC (between 2012 and 2019) and Research Associate at ELIAMEP (Hellenic Foundation for European and Foreign Policy) in Athens since 2018. From 1982 to 1997 and 1999 to 2001, Dr. Michalopoulos served as a senior World Bank official including as Director for Economic Policy and Senior Economic Advisor for Europe and Central Asia. Prior to the World Bank he worked for the US Agency for International Development (1969=1982) finishing as its Chief Economist (1981-2). He was also Special Advisor to the World Trade Organization (1997-1999) and taught economics at several US universities. Following his retirement from the World Bank he served as a development advisor to governments and international organizations including the World Bank, IMF, UNCTAD, the EU Commission, GTZ and the UK DFID on international trade, finance and development. He is the author of several books and over 100 articles and monographs on these subjects. His previous books include Aid, Trade and Development and Migration Chronicles. Dr. Michalopoulos is a graduate of Athens College and holds a PhD in economics from Columbia University in New York City, N.Y. USA.

Summary:

The prospects of the Greek economy are mostly good with growth continuing for the fourth straight year. But there is a sense of disappointment, as the recovery has not been very strong and pre-crisis income levels will not be regained for another decade. There are two main reasons for the sluggish recovery: The European creditors have imposed on Greece the requirement to run a primary budget surplus of 3.5% of GDP for five years to ensure that they get repaid—a requirement that constricts growth of the Greek private sector—through heavy taxation of consumers and business. And domestic investment is sluggish, although there are plenty of unutilized resources, such as those provided by the European Structural Funds. There is a need for a new deal with the European Institutions: the Europeans should be more relaxed about getting repaid because of Greece's much improved access to the European capital markets and be willing to accept a Greek government commitment to a significantly lower

primary budget surplus for the next several years. In exchange the Greek government should commit to a commensurate increase in domestic investment through reforms of the banking sector as well as greater public sector investment spending.

It’s Time for a New Deal

- Greece’s recovery is solid but weaker compared to other crisis-hit countries
- Over-ambitious fiscal targets and structural weaknesses inhibit growth
- A new deal is needed, between Greece and the EU, involving less fiscal consolidation in exchange for continued structural reforms and, in the short-term, more public investment
- Lower rates for Greek government bonds and a large cash reserve are a shield against potential risks
- The current circumstances present an opportunity for a growth-enhancing deal that should not be missed

The beginning of a new year, indeed a new decade, is a good time to look ahead at the prospects of the Greek economy. It is also roughly six months since the Mitsotakis government took office and it is useful to look back and review how they have been doing.

The news is mostly good. Greek public sentiment about economic prospects is at the highest level since the economic collapse more than a decade ago. In 2019, the economy grew for the third year in a row—originally estimated a modest 1.8%, but recently revised to more than 2% which is higher than the EU average, and everybody is predicting growth for 2020.

Still, there is a sense of disappointment: The forecasts continue to talk about growth at around 2.0% per annum for the next decade. Which means that Greece, having lost 25% of its per capita income during the crisis will be able to regain its earlier level maybe in another decade, maybe by 2030. And although many jobs have been created, unemployment is still 17%, the highest in the EU.

The IMF and the European Institutions bemoan the fact that the recovery has not been stronger. Indeed, the IMF points out in its most recent report that Greece’s recovery has been weaker than that of Ireland, Portugal, Spain and, I would add Cyprus, all countries that went through a crisis in the last decade. It is important to ask why that has been the case and what can be done about it.

To be sure there are many differences between Greece and these other countries, including the nature of the problem and the policies each pursued to get out of their difficulties. But there is one major difference worth pointing out: in none of the cases were these countries forced by their creditors to sustain a government budget surplus of the size and duration that was forced on Greece. Running a budget surplus of 3.5% for five years and a continued surplus of 2.0% for the indefinite future in order to maintain sustainability of the outstanding government debt—i.e. so as to ensure that the creditors are repaid, is a straightjacket that constricts the capacity of the Greek private sector—through heavy taxation both of consumers and business. It takes the money away from those that can spend it and makes it impossible to have the kind of rebound one would expect from a country coming out of a crisis.

But there is nothing magic about the 3.5% target: The IMF which is not known for recommending fiscal laxity said in its recent report: " Staff urged the authorities to seek consensus with European partners on a lower primary balance target, given the large negative output gap and the need to bring down high tax rates and address unmet spending needs." 1 It is clear that a lower surplus will stimulate growth and thereby improve rather than reduce debt sustainability, the concern of all creditors and in Greece's case, the EU, which holds almost 70% of its external debt and now plays a dominant role in the continued surveillance of the Greek economy.

And there is a second difference, not mentioned by the polite economists who write the Commission or IMF documents: The Greek government continues to allocate close to 2% of its GDP of its budget to defense, as part of its NATO commitments, much higher than any of the other governments which did better in getting out of the crisis. This of course limits the government's capacity to use revenues for more productive purposes, such as improving the infrastructure, which is urgently needed. The reason for this defense expenditure is not the recent Trump harangues. It is due to the presence of a bellicose Turkey, manifested by continued incursions of Turkish aircraft over the Greek airspace and occasional statements of Turkish officials of the need to 'reexamine' the provisions of the Treaty of Lausanne that established the present borders between Greece and Turkey.

The Greek economy suffers from a variety of structural deficiencies that need to be addressed: there is too much bureaucratic intervention in the private sector: Despite some recent improvements, Greece ranks behind practically all EU members in the World Bank's "Ease of Doing Business" index; there are many oligopolistic structures at both the retail and suppliers level: why should a cup of coffee cost more in Athens than in Bonn? There are closed professions earning large rents; there is a sclerotic justice system involving large delays. All these need to be addressed. According to both IMF and the last Commission report, the Mitsotakis government has made a good start in most cases—good enough for the Commission to

[1] IMF "Staff Report for the 2109 Article IV Consultation", Washington DC: IMF, October 28, 2019

conclude in its more recent report that "Greece has taken the necessary actions to achieve its specific reform commitments for mid-2019. Further actions will be crucial to complete, and where necessary accelerate, reforms.2 But their impact will only be felt over time. What are the priorities now?

The greatest and most urgent short-term need is to revitalize investment. Greece ranks last in the EU in the proportion of its GDP devoted to investment. Growth, inclusive and sustainable, does not happen without a spurt of investment. Unfortunately, a lot of the problems derive from a banking sector that is still struggling and whose return to health will take years. Both the IMF and the Europeans have been correctly making banking sector improvements a key priority.

The government must also step in and do its part: There are about 7 billion euro waiting to be contracted from the European Structural Investment Funds, assistance provided by the EU under the 2014-2020 program which have yet to be contracted and may be lost. Only 37% of the funds budgeted six years ago have been spent.3 Amazingly, though both the IMF and the European Surveillance teams have highlighted the importance of raising domestic investment and decried the fact that the government investment budget has been underspent, they have said nothing about this issue. ESPA, the Greece-EU agreement that outlines the plan for the use of Structural Funds is not even mentioned in their reports which cover practically all government agencies and activities.

The Mitsotakis government proposed stimulus to the construction sector through tax breaks, which could also be useful as the sector has been the motor of the Greek economy in the past, serving the Greek penchant for second homes. But one has to be careful: speculation in the sector was part of the bubble that burst in 2009, and the sector presents many opportunities for tax evasion.

Since August 2018, I have been arguing for a new deal with the Europeans, involving less budget stringency and conditioned on the Greek governments continuing their efforts in structural reforms.4 As shown by the largely positive reports of all the surveillance missions, by and large, the Greek governments have done their part—albeit Tsipras' with a few 2019 pre-election shenanigans and setbacks. The time has come for a new deal: the Europeans should be more relaxed about getting repaid and be willing to loosen the requirement of running a large primary budget surplus. In exchange, the Greek government should explicitly commit itself to a target of increasing the amounts it spends on investment.

[2] European Commission, "Enhanced Surveillance Report, Greece, November 2019", Institutional Paper 116, Brussels, European Commission, p.12.
[3] www.anaptyxi.gov.gr accessed January 18, 2020.
[4] See *Kathimerini,* August 19, 2018

Greece's demonstrated access to the capital markets in the last two years, means that the Greek government can borrow in these markets the sums needed to service all its forthcoming obligations, including the roughly 5.5-billion-euro annual interest bill. Indeed, recently it was able to borrow enough at the prevailing very low interest rates to repay in advance 2.7 billion euro of high cost money owed to the IMF.

To be sure there are future risks: a global economic slowdown is always possible hurting Greek exports and tourism; BREXIT and the US President introduce uncertainties; and the Greek economy has strong economic links with countries in its dangerous neighborhood. But the government has already built sufficient large reserves, in the range of 32 billion euro to address such contingencies.

The European Institutions will be performing their fifth Enhanced Surveillance in the next few weeks. This presents the opportunity for a deal: the European Institutions should reduce the expected primary surplus by 2-3% of GDP and in parallel the Greek government should commit to a target of an equal increase in the government investment budget spending. This is a pro-growth deal. The opportunity should not be missed to make it.

Λεωφ. Βασ. Σοφίας 49, 106 76 Αθήνα, 49 Vas. Sofias Ave., 1067 76 Athens Greece, T +30210 7257110, F +30 210 7257114