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On May 18th - 19th, a group of senior stakeholders, distinguished academics and commentators gathered at the London Business School to discuss the ongoing Greek Crisis. The group included:

- Former ministers of Finance, Labour, and Economy from Greece and other European Union (EU) countries.
- Advisors and officials from the Greek government.
- Senior bankers from Greece.
- Senior economic policy-makers from the United Kingdom, the United States, and continental Europe.
- Journalists and commentators from international news media and the press.
- Influential academics (many of whom are heavily involved in policy) from continental Europe, the UK, and the US, with expertise in economics, finance, banking, strategy, and political science.

Our discussion covered a variety of issues, such as structural reforms in the labour and product markets, the ongoing stress of the Greek banking system, and the delicate issue of debt restructuring. Our objective was to bring the various stakeholders closer, understand the (economic and political) constraints, learn from the successes and mistakes of the past, so as to move forward in a constructive manner that will safeguard Greece's position in the euro area and the core of the EU. The conference aimed at facilitating the discussion between Greece and the international partners (the EU, the IMF, and the ECB) in order to reach a new deal. Our intentions were on the one hand to inform the discussions among the partners and on the other hand to bring parties closer on the substance of what should be done. This is key for facilitating an agreement for the years to come. While participants came from diverse backgrounds, a remarkable consensus for future directions emerged. For example there was a unanimous agreement that Greece should quickly reach a new agreement (contract/memorandum) with its international peers. And all participants stressed the need to restore trust, which unfortunately has evaporated over the past years.

In this report, we go over some of the major issues summarizing the key recommendations and policy proposals that came out from the discussions. These views do not always represent the entirety of the participants, but they have been informed by the group discussions.

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1. Executive Summary

The time for Greece is running out and a deal for the completion of the current (second) economic adjustment programme and for the design of a subsequent (third) programme (contract) must be made as soon as possible. Unfortunately, the massive economic and political uncertainty, the back and forth of both the previous Greek administration and the newly-elected government, the opposing views of politicians in the coalition government, the polarization of public opinion and the unacceptably high unemployment and social exclusion rates have created an explosive politico-economic environment. At the same time growth is sluggish, the administrative capacity is weak, institutions are malfunctioning and there is limited fiscal space (especially because the economy reverted back to a recessionary spiral in late 2014 and in 2015). We thus believe that the Greek government can be of help, by introducing the several key issues on the negotiating table. These issues should be at the core of the new agreement (memorandum, contract).

1.1. General Principles

- **An agreement must be made as soon as possible as it is vital to reduce uncertainty.** This is a *sine qua non* condition for the restoration of economic, political and social stability in the country.
- The Greek government - and the Greek political system more generally - need to claim **ownership** of the new programme. The new economic adjustment programme should be tailored to the idiosyncrasies of the country; the mistakes of the past should not be repeated; and the programme should be designed by Greeks, utilizing the abundant human capital and expertise of Greek academics, businessmen, and former politicians. Although time is running out, it would also be desirable to engage the public, social groups, NGOs, etc.
- Emphasis should be put in **communicating** both the immediate goals and the medium-run objectives of the programme to the Greek people. This is needed so as to raise legitimacy and bring much-needed social support for reforms in public administration, product markets, the judicial system, etc.
- It is essential to restore **trust**. Greek government officials should abandon their polemical rhetoric against the EU, the ECB, and the IMF. Likewise EU officials should stop insulting the Greek people and elected officials. Both sides need to learn from the mistakes of the past and realize that all stakeholders have much to gain if the Greek economy and society recover from the devastating crisis.

1.2. Priorities for the Completion of the Current Economic Adjustment Programme

- **The government should continue sound macroeconomic policies on the fiscal side.** First, given the dire conditions of the economy, the target for 2015 fiscal balance should be for Greece to run a tiny fiscal surplus. The troika should show flexibility on this and lower both the initial unrealistic target for a 3% of GDP goal and the revised target for 1%-1.5%. Even running a balanced budget for the current fiscal year would require significant fiscal measures that could destabilize the fragile Greek economy. And unfortunately the tax bill will most likely hit again workers and pensioners – as there has been no serious effort in tackling tax evasion over the past year. (The tentative proposals of the Greek government to massively raise income taxes, VAT, and corporate taxes are unfortunately in this direction). Second, the Greek administration should commit to primary budget surpluses of 1.5% - 2.5% of GDP for 2016-2018, which could perhaps increase further in subsequent years if growth resumes.
- **Fiscal austerity would be counter-productive.** Given the huge liquidity squeeze, the oligopolistic nature of product markets, and the small degree of openness, further fiscal austerity would be quite recessionary (due to strong Keynesian effects).
- The government should also continue past reforms on social security that aim **establishing a sustainable pension system**. A fairer, more transparent, and viable social security system is needed. The government should cut down on “early retirement” schemes that are both inefficient and unfair. Given the size of “exemptions”, simply raising the general retirement age is not a priority, though this could slowly increase for new workers. And the reforming the supplementary insurance funds should proceed. Since this will be associated with pension cuts (sizable in some cases), the troika should allow a brief transition phase. Pension cuts in the current economic environment would be both fiscally unproductive and socially unjust.
- **The government must signal credibly its commitment to deep structural reforms that will raise the competitiveness of the Greek economy.** Strong signals are needed to reveal government’s political will to tackle endemic corruption in public administration, tax evasion, and the complex oligarchic system that links political parties to media and the administration. This requires concrete actions and not words.

1.3. Towards a New Economic Adjustment and Growth Programme

- Looking forward, the focus of the new contract-programme should not be on the fiscal side. In spite of the severe downturn, Greece has managed a remarkable fiscal adjustment over the past years. All attention should go to improving the **deep pathologies of the Greek economy, such as weak state capacity, malfunctioning and captured institutions, weak protection of investors, inefficient and absurdly slow courts, populist policies, and distrust.**

- The key objective is to create a new business environment, so as to allow the forces of **creative destruction** to operate. The Greek economy needs a major reshuffling and a paradigm shift, reallocating capital, labour, and human capital to export-oriented firms and in skill-intensive sectors.
- The first priority should be to reform **product markets** that are still oligopolistic, with numerous (administrative, regulatory, legal and other) barriers to entry. There is much to be done to **abolish unnecessary red-tape costs** that have adverse effects on attracting foreign and internal investments. In spite of recent improvements and some reforms, Greece still scores very low in most cross-country measures proxying the ease of doing business.
- A second priority is to improve and modernize the **legal framework of property rights, investor protection and corporate governance**. Greece suffers from both low-quality legislation and weak de facto protection from courts. And recent legislative measures (by both the previous and current administration) regarding the personal liability of shareholders in limited liability companies have made things worse.
- A third priority is the **massive reorganization and restructuring of the public administration**. Public administration should become non-partisan and detached from political parties and the political cycle. In this regard -and as a minimum- the Greek government should respect the independence of the Bank of Greece, the Hellenic Statistical Authority, and the Hellenic Financial Stability Fund. At the same time the administration should promote independence of tax collection mechanisms and various supervisory-regulatory agencies (e.g., Hellenic Capital Market Commission). Unfortunately, some early decisions of the new Greek government in this regard are highly partisan, following the paradigm that (with some exceptions) has characterized Greek politics since independence.
- There is a need to redesign the public administration in order to improve significantly the administrative capacity of the state. Public administration must finally become non-partisan and detached from political parties and the political cycle. As a minimum initial step, the Greek government should respect the independence of the Bank of Greece, the Hellenic Statistical Authority, and the Hellenic Financial Stability Fund. At the same time the administration should promote independence of tax collection mechanisms and various supervisory and regulatory agencies (e.g., Hellenic Capital Market Commission).
- A fourth (related) priority should be reforming **tax collection**. A massive simplification of the tax code is desperately needed, as well as the computerization of tax offices. Among other measures, the government should also recruit IT experts (and the institutions should not block such hires on budgetary grounds). And incentives should be offered for electronic payments and electronic clearance of VAT. It is also vital that the government respect and further safeguard the autonomy and independence of the chief tax officials, and not follow the practice of previous administrations that continuously interfered with tax officials.

- A fifth priority should be the modernization of the **judicial system**, which is absurdly slow, extremely formalistic, inefficient and unjust. The Greek government should build on recent reforms, but rather than employing an incremental approach, it should proceed aggressively, as the system needs a “big push”. Dealing with the massive case backlog – which is especially pronounced in administrative and tax courts - is needed. The government and the institutions should consider recruiting part-time magistrates and opening courts on weekends and during the summer. Medium-term reforms include the establishment of specialized courts, promoting alternative dispute resolution mechanisms, and improving checks and balances (which given the lack of computerization and the chaotic situation in Greek courts) are absent. Unfortunately it seems that these issues are not part of the agenda, something really worrisome as they are evidently linked to Greece’s inefficient economy and unjust society.
- A sixth priority is dealing with the weak **position of Greek banks**. In spite of the successful bank recapitalizations of 2013-2014, the interaction of the economic downturn, uncertainty, and deposit withdrawals has considerably increased non-performing-loans (NPLs). Restoring liquidity and private credit are necessary conditions for economic recovery. In this regard, the institutions and the Greek government should reach an agreement moving NPLs to an asset management company (AMC – colloquially, a “bad bank”) financed with the money that has been put in a special account of the ESM-EFSM (approximately 10 billion euros, though more is needed). However, the state’s involvement in the AMC and also in other financial institutions should be minimal. In the past, Greek banks have been used by the political system for patronage, to protect insiders, and to buy media support. This cannot continue. Additional money for the AMC could come from specialized institutional investors, such as private equity firms specializing in NPLs. And legal reform is urgently needed in bankruptcy-insolvency, so to expedite the process and efficient firm restructuring.
- Seventh, as Greek labour markets are already quite flexible (de facto the Greek labour market had been quite flexible even before the crisis, as labour legislation was not enforced) and wages have fallen considerably, **further liberalization of labour markets should not be a priority**. The troika should not insist on that. Some interventions that are perhaps needed (on firing restrictions for large corporations) can be re-evaluated when growth resumes or can be dealt in an ad hoc basis (for example if needed to attract large foreign direct investment).
- Rather than focusing on labour market flexibility, the troika (mostly) and the Greek government should design a coherent, complete, and just social protection program. Greece must rebuild unemployment benefits from scratch and re-evaluate various social protection programs. The government should re-evaluate the criteria for the various social allowances, as the system is characterized by pervasive corruption. Moreover, with assistance from the institutions, the Greek government should extend the minimum guaranteed income scheme throughout the country. (While the institutions are pushing in this direction, the new government has done much).

- The Greek government should take concrete measures to increase **transparency** in public administration. This is essential for raising accountability. The administration should promote rather than endanger institutions such as @diavgeia (i.e., the obligation to publish on internet all the decisions of the government and public agencies).
- A necessary condition for improving the efficiency of public administration and the judicial system and tackling corruption and tax evasion is the **installation of modern ICT** (information and communication technology) systems. For example, the government should proceed quickly with the computerization of courts (E-Justice system) that has been slowed down considerably over the past year.
- The government has to pursue reforms that will drastically tackle the issue of '**insiders-outsiders**' that is pervasive in most economic activities. This will yield both efficiency gains and lower inequality.
- On **debt restructuring, debt restructuring** there are two facts that all stakeholders must acknowledge. First, after the PSI agreement (in 2012) with the sizable extension of maturities and the reduction of interest, Greece's debt service cost has fallen considerably for 2016-2022. Second, the nominal value of debt as a share of GDP continues to be large, something that raises concerns of debt sustainability especially after 2022. There was a consensus in our meeting that at this stage and given the political constraints some debt relief could be offered by further extending the maturities and lowering interest rates. And perhaps once the Greek government proceeds with structural reform and demonstrates its willingness and commitment to the programme, the EU could offer some reduction of the face value of the debt.

All these measures require **trust and commitment**. Greek government officials should abandon their polemics against the EU, the ECB, and the IMF. Likewise EU politicians and officials should stop casting aspersions on the Greek people and their elected representatives. Both parties should learn from the mistakes of the past. All stakeholders have much to gain if the Greek economy and society recover from the devastating crisis.

2. Background¹

Greece has suffered a devastating, deep and prolonged recession that has already lasted seven years with output contracting by more than 25% and unemployment exceeding 25% (and reaching 30%). Youth unemployment exceeds 50%, and there is an evident exodus of the youth and a brain drain. At the same time public and private investment has collapsed (dropping from approximately 25% of GDP in 2007 to 15% in 2014). And a sizable fraction of the Greek people lives under the poverty line.

In spite of the huge economic and social costs, macroeconomic, financial, and political conditions have not stabilized. Indeed, uncertainties have increased considerably over the past year, initially with the volatility of the positions vis-à-vis the commitment to the programme of the previous Greek administration (mid-2014), then with the elections for the President of the Republic (end-2014), and since January-February with the polemical rhetoric, delays, inconsistencies, and indecisiveness of the new Greek government. Unfortunately these policy mistakes and the associated uncertainty have pushed the economy back into a recessionary spiral: negative growth rates in late 2014 and 2015, some increase in unemployment, deposit withdrawals, drop in investment, and a liquidity squeeze.

Relations between Greece and its European peers and international lenders are fragile, marked by manifest distrust. At the same time within Greece, there is rising polarization of views towards Greece's role in Europe.

The February 2015 Euro-group agreement between the newly-elected Greek administration and the institutions (the IMF, the EU, and the ECB) was tentative and unclear, leaving most key issues to be resolved very soon. If they are, there will most likely be a follow-up multi-year agreement (contract) and additional funding – a new bailout programme. While nowadays there are rumours of another extension, given the huge financing gaps, the drop in output, and the lowering of the fiscal surplus targets, it seems unavoidable for Greece to have another economic adjustment programme.²

The outcome will have huge significance not only for Greece, but also for the economic governance of the euro area and the future of the European Union. Many things have gone wrong in the negotiations (which unfortunately started quite late in mid-spring). This is a major risk both for

¹ We would like to thank Dimitri Vayanos, Nikos Vettas, Chris Pissarides and Costas Meghir, editors of a forthcoming MIT Press book on the Greek economy for distributing some of the book's chapters to serve as background papers for the discussion.

² The new government is denying that it will sign a new "memorandum" with the institutions. Yet in many official documents the government has signalled that it looks forward to a new contract with the EU, the ECB, and (probably) the IMF.

the fragile Greek economy and suffering Greek society, but also for Europe, its economic recovery and its ideals of cohesion and support.

Elected politicians, policy makers, experts, academics, and commentators from all sides must establish a constructive dialogue, build bridges, and cultivate much-needed trust. All parties should resist playing a blame-game and try to come up with a realistic (respecting the political constraints in all Eurozone countries), comprehensive, and multi-faceted plan that will focus on the deep structural deficiencies of the Greek economy and state – rather than myopically on fiscal issues, a key mistake of the previous programmes, particularly in their implementation).

Greece belongs to the core of Europe. The ideals of the classical period of respect, tolerance, democracy, an open society, civic virtue, and search for knowledge have served as the basis of European values since the Enlightenment. And the European Union itself is based on these values. It is thus vital for Greek policy-makers and their counterparts elsewhere in the EU to reach a viable, durable agreement that will secure Greece's position in Europe and the EU's cohesion.

London Business School therefore took the initiative to invite government officials, former Ministers of Finance and the Economy from Greece and other EU countries, leading journalists and commentators, bankers from Greece, and distinguished academics for a frank, off-the-record discussion of the key issues in an effort to create bridges and cultivate trust.

This event builds on a previous similar LBS initiative at the early stages of the Greek crisis (in October 2010), which led to a [report on structural reforms and changes in the public administration](#); and an initiative organized in Athens, by LBS faculty, alumni and students in January of 2012. [That event](#) brought together 400 select business leaders, policy makers, politicians and opinion makers, led to a broader initiative, *RedesignGreece*, which spearheaded a concrete project to help address some of the systemic problems in the Greek public administration. This project consisted of a set of prizes, with money obtained through external fundraising, to reward public servants who would come up with solutions to issues identified by specific authorities as major priorities. The objective was to combine the power of crowdsourcing while providing recognition for agents of change. Proposal evaluation featured a panel of international judges. This was intended to help implement change management, a neglected and un-resourced part of the Troika programmes. Finally, through its faculty involvement, LBS has participated in the support of [ReloadGreece](#), a charity aimed at supporting Greek entrepreneurship through the mobilization of the diaspora and peer-to-peer support and mentorship of aspiring Greek entrepreneurs.

3. Setting the Agenda, Lessons, Successes, and Mistakes

3.1. The Issues

Greece is the EU country that received the biggest lending by the Economic Adjustment Programmes (EAPs) of the institutions (the IMF, the EU, and the ECB), that assisted countries in the euro area during 2009-2014 (Ireland, Portugal, and Cyprus). Nonetheless Greece has not managed to achieve economic recovery. While growth resumed in the first semester of 2014, economic activity stalled in late 2014, and Greece has re-entered a recession in 2015. The first session of our meeting sought to understand what went wrong and why it has been so hard for the Greek economy to stabilize and rebound. Participants provided an overall assessment of the implementation of the EAPs in Greece, discussing the mistakes made and the lessons that can be learnt from the five years of economic adjustment. Policy-makers should reconsider the design of the new (third) economic adjustment programme in the light of the conclusions.

3.2. Conditions at the beginning of the crisis

Most of the speakers stressed the initially difficult economic conditions that prevailed in Greece at the outset of the programme.³

First, public finances were in dire condition. During 1999-2008 Greece run consistently large budget deficits (on average 6% of GDP), while 2009 was marked by a record fiscal deficit of 15.9% GDP. [Other EU countries also ran sizable but much smaller deficits: the average fiscal deficit in Portugal during this period was around 4% and in Italy around 2.8%. In contrast Spain and Ireland ran small fiscal surpluses during this period.]. As of 2008, Greece had also the highest public debt (as a share of GDP) across the euro area (around 120%). In spite of the robust (real and nominal) growth of the 2000s, public debt increased by approximately 20 percentage points of GDP).

Second, since the inception of the euro Greece experienced a sizable drop in competitiveness that resulted in unprecedented external imbalances. During 1999-2008 Greece's current account deficit was on average 9% of GDP, while in 2008-9 it reached 14%. The trade imbalance in Greece in 2008 was -32.2 billion euros, while in 2009 the imbalance was -25.4 billion

³ See Galenianos ("The Greek Crisis: Origins and Implications", 2014, [mimeo](#) Royal Holloway University) for an overview of macro-economic conditions at the beginning of the crisis in Greece and a comparison with other euro area member countries. Angeletos and Dellas ("Greece and the Euro", 2015) discuss (theoretically and empirically) the costs and benefits of Greece's participation in the euro area. In very recent work, Muller, Storetletten, and Zilibotti (Sovereign Debt and Structural Reforms, 2015) present a dynamic macro model stressing the various trade-offs in the implementation and monitoring of the adjustment programme.

euros. Although all countries of the European periphery posted sizeable current account deficits, the trade balance was the worst in Greece and Portugal.

Third, labour costs increased considerably, lowering the competitiveness of Greek firms both in international markets and in local markets, where there was a substitution from locally produced goods to imports. In the period 1999-2008, unit labour costs in Greece increased by more than 30%, while in Germany the cumulative increase during the same period was around 5%. Price inflation was also consistently higher in Greece during the 2000s, as compared to other euro area member countries, reflecting among others the oligopolistic nature of Greek product markets. In particular average harmonized inflation over 1999-2008 floated around 3%-4%, while the euro area average was around 2%.

Fourth, state capacity was weak and administrative-bureaucratic efficiency abysmally low. Greece (and to a lesser extent Italy) scored the lowest across the various proxy measures of the quality of government and bureaucracy produced by the World Bank, the World Economic Forum, and other NGOs.

Fifth, Greek product markets were extremely rigid, there were numerous administrative barriers to entry (red tape), most sectors were highly oligopolistic (some even monopolistic), the licencing regime for most professions was anachronistic. The structure of product markets has been a key factor lowering Greece's competitiveness and raising inequality and unfairness. Moreover, despite the strong growth of the late 1990s and 2000s, Greece's rankings in the various indicators of international competitiveness regarding ease of doing business deteriorated.

Sixth, while labour market legislation was sclerotic on paper, de facto the labour market was quite flexible at least for small and medium sized enterprises – that usually operate in a semi-formal status - as the laws were rarely enforced. But the stringency and formality of labour laws were impediments for large and export-oriented firms.

Finally, investor protection was poor both because the quality of corporate and bankruptcy law was very low (with constant changes) and because the court system is painfully slow, formalistic and inefficient.⁴

Many participants agreed that these issues were to some extent known, they were not fully understood in the beginning of the crisis (2008-2010). This (partly explains the optimistic scenarios and the failure of the initial economic adjustment programme, which largely ignored the deep structural deficiencies of the Greek state and economy.

⁴ Arkolakis, Doxiades, and Galenianos (“[The Challenge of Trade Adjustment in Greece](#)”, 2015) provide a thorough analysis of the macro-economic conditions and the challenges of external adjustment at the beginning of the crisis and during the past five years.

3.3. The Adjustment Programme

In the beginning, the EAPs aimed to tackle the macroeconomic imbalances of the Greek economy. The focus was on bringing down the ballooning fiscal deficits and correcting external imbalances mostly by lowering labour costs ('internal devaluation'). Another key objective of the initial agreement (of May 2010) was restoring market confidence, eventually allowing Greece to gain access to the international capital market. The second economic adjustment programme included many provisions on structural issues, related to closed professions, licensing, competition in product markets, and administrative capacity (mostly in the second programme). Yet these issues were not prioritized in practice.

3.3.1. Successes

Although the implementation of the EAPs was partial and took place when the economy was in a free fall, there have been some successes, which however came at huge social costs. In particular:

1. Greece managed to close the huge fiscal deficit that reached 15.9% of GDP in 2009. The primary fiscal deficit that exceeded 10% of GDP in 2009 was minimal by 2014.⁵
2. The debt restructuring of 2012 brought debt into a supposedly sustainable track, by imposing substantial haircuts (PSI, private sector involvement), extending the average maturity (from 5-6 years to 17 years), and providing a "grace period" with small interest costs (2016-2022).
3. Greece avoided bank runs; in spite of the massive strain on the banking system, there has been no deposit bail-in (as in Cyprus). Moreover banks were successfully recapitalized with some private sector participation (in 2013-2014). And banks had managed to raise some capital from international debt markets in 2013-2014.
4. There were some improvements in competitiveness, thanks to some modest reforms in product markets (this has been reflected in most product market regulation indicators of the OECD and the World Bank). Competitiveness has also increased as, unit labour costs have fallen considerably..
5. Some reforms in public administration and the judicial system took place, though conditions are still appalling.
6. There have been many interventions in tax collection, such as appointing independent director general in the Ministry of the Economy and setting up specialized public prosecution office for

⁵ There is some ambiguity on whether Greece ran a primary fiscal surplus in 2014. We abstain from this issue focusing on the big picture of the sizable adjustment.

economic crime. [Actually some big, important cases regarding banking fraud have been brought to court, though still have not been fully resolved.]

7. Although partial, interventions in the social security system have helped to improve its sustainability.
8. The trade (and current account) deficit had almost closed (as of 2014 it was around 4.5 billion euros), though the adjustment has come almost exclusively via the drop in imports rather than an increase in exports (which has been modest).

3.3.2. Failures and Mistakes

Nevertheless, there have been some evident failures of the adjustment programmes –some regarding its design, mostly in its implementation. While there was some disagreement on how significant those mistakes were, there were also some common views on the key flaws that we summarize below. All participants expressed hope that these mistakes will not be repeated with a new (third) adjustment programme.

1. The economic costs (fall in output, massive drop in investment, increase in unemployment) were huge, far greater than the forecasts of the troika and the Greek government. There was an enormous cumulative GDP loss of over 25%, one of the greatest in the economic history. Investment (as share of GDP) fell from 23% in 2008 and most of the previous decade to 13%-14% in 2012-2014. This drop (which applies to all components of investment) is even larger if one factors in the sizable drop of output during this period.
2. Due to the malfunctioning of the welfare state, social costs – as captured by poverty rates, social exclusion, etc. - have been enormous and vastly underestimated.⁶ The social safety net proved inadequate or even non-existent, with the consequence that social exclusion increased considerably. Unemployment soared from 8%-10% to 27%-28% in just 4-5 years.
3. Market confidence was not restored, and Greece did not manage to access international capital markets.⁷ This not only affected fiscal conditions but also was particularly harmful for the banking sector, which lost close to 50% of its deposits (if one includes the first five months of 2015, when bank deposit withdrawal accelerated).
4. The troika institutions underestimated the impact of austerity – the size of the “fiscal multiplier”. Unfortunately the discussion centered on the size of the “average” multiplier, estimated around 1.1-1.4. Yet since the Greek economy (a) is relatively closed; (b) with oligopolistic product

⁶ For example, according to some estimates there are currently 400,000 families in Greece with children when no one of the parents is working.

⁷ Early 2014 the Greek government managed to attract some capital via the international bond market, but this proved to be temporary.

markets (yielding a high-degree of price rigidity) and (c) an adversely affected banking system, the multiplier estimate should have been way higher, as all these features imply strong Keynesian effects.⁸

5. Both the troika/institutions and the Greek government under-estimated the low levels of administrative capacity of the Greek state. Many measures tackling structural deficiencies simply could not be implemented by the various state agencies that lacked necessary specialized personnel, ICT infrastructure, and know-how.⁹
6. Debt relief (the PSI agreement) came late, so its benefits were much lower than it would have brought in 2010 or even in 2011 (of course, one cannot accurately estimate what the costs to Europe at that stage would have been). Moreover, the agreement included many exemptions. Thus, most participants argued that some further debt restructuring is needed, most likely by further extending the maturity of the debt held by the official sector and further lowering interest payments. Actually there is some preparatory work here by the advisers of the Greek government and the IMF that can serve as the basis for the discussion.
7. There was very little emphasis on product market reforms. Interventions to increase competition, reduce red tape, and liberalize closed professions came late (when popularity was already lost), were partial, incomplete. The government (perhaps due to political pressure from insiders and the lack of state capacity) was reversing implemented policies.
8. The privatization program has been a failure; neither the troika nor the Greek government factored in the various institutional constraints (e.g., on the sale and leases of public land) and the uncertainty.
9. The sequence and priorities of structural reforms have been problematic. The emphasis should have been on product markets – rather than on labour markets - as the initial conditions were far worse and because it was important to bring down prices and compensate workers for the drop in nominal wages. Due to the high number of very small (one-two workers) and small (up to 10 workers) firms, the Greek labour market was in practice quite flexible. Thus while competitiveness when measured by unit labour costs has been restored, when measured by final prices, there has been minimal improvement.¹⁰

⁸ See for example Farhi and Werning (“[Fiscal Multipliers](#)”, mimeo Harvard and MIT, 2015) on heterogeneity of fiscal multipliers. Corbi, Papaioannou, and Surico ([Federal Transfer Multipliers. Quasi-Experimental Evidence from Brazil](#), NBER WP 20751/2014) show that local multipliers (in a currency union) are large (around 1.7-2.1). Most importantly the authors show even higher multipliers for isolated (closed to trade) municipalities and cities where liquidity constraints are large.

⁹ This point is also emphasized by IMFs’ Ex-Post Evaluation of the 2010 Stand-By Arrangement (see [here](#)).

¹⁰ There is nowadays a discussion between the Greek government and the institutions to increase considerably value added tax in electricity. This will have adverse effects on the competitiveness of Greek industry –that already faces high energy prices from the state monopolist (DEH).

10. There has been little progress in improving public administration. The discussion was and to some extent still is erroneously centred on the number of public sector employees, neglecting the fact that the problem was their low productivity, stemming from labour misallocation, lack of ICT, political interference, lack of accountability, transparency and monitoring.
11. The Greek government did not claim ownership of the programme. Politicians and government officials were putting the blame for most measures on the troika, rather than arguing that these measures were essential to improve the functioning of the economy. This applied not only to fiscal measures (such as lowering public sector wages and salaries and cutting expenditure), but also to policies aiming to improve institutions and raise state capacity.
12. There was very poor communication of the goals and objectives of the programme to the people. This led to opposition even against policies and measures aiming to break cartels, improve administrative capacity, tackle corruption, and reduce red tape. It seems that this failure stemmed both from political tensions and improper communication from the government. The local media's role has also been quite negative, as they quickly adopted a populist, often anti-European agenda.
13. Even within the troika, there were heterogeneous and quite often opposing objectives. This contributed to the loss of legitimacy of the programme and its polemical criticism from parts of the Greek political system.
14. The lack of ownership and the poor communication were significant factors in the loss of support for the memorandum, which was quite high in the beginning (mid-late 2010). This led to fierce political opposition, populism, and polarization, which have all been major impediments to the restoration of normality and stability in the Greek economy and society. The lack of political consensus even for basic reforms was a key difference in Greece as compared to other countries, such as Portugal, Ireland, and Spain that implemented adjustment programmes under some political consensus.
15. Political will was not particularly strong and seems to have fallen over time. For example, former Greek ministers and officials revealed that they spent a considerable amount of time convincing other politicians in the government coalition of the need for reform.
16. The EAPs did not succeed in building trust, social cohesion and involving locals in the way that the Marshall Plan had done in the past. Greek society was characterized by low levels of trust and civic capital at the onset of the crisis, and all evidence suggests things have deteriorated further, with trust towards European institutions, local political parties, courts, and the government falling sharply.¹¹

¹¹ These issues are discussed in detail in Papaioannou ([Trusting in Europe?](#), Center for European Policy Studies Report. 2013).

3.4. Looking Forward

Greece must focus on a growth paradigm that puts the modernization of the state at its centre. It should design the path of a process of structural reforms on that basis. The new government has to reach an agreement with the institutions immediately. There was a consensus (even among Greek officials) on the need to build trust, for example by committing to primary fiscal surpluses and implementing deep reforms in public administration and tax collection. Growth might come now only if the government were ready to liberalize the product market and change the existing status quo that protects well-established vested interests.

4. Structural Reforms (Labour Markets, Product Markets, Public Administration and Legal System)

4.1. Introduction

As illustrated by the rising current account (trade) deficit during the period 1999-2008, Greece competitiveness has been deteriorating steadily since the inception of the single currency and was quite low in the beginning of the crisis. As of 2007, the Greek trade deficit exceeded 15% of GDP, with imports being close to 39% and exports around 23% of GDP. The same picture emerges from survey-based competitiveness indicators, reflecting flexibility of labour market institutions, conditions/competition in product markets, the quality of legal institutions and courts, bureaucratic efficiency, and corruption in public administration, among others. While Greece's rank in the World Economic Forum's Global Competitiveness Index (out of approximately 135 countries) was 35-37 during 2001-2004, it went to 83 in 2010, reaching 96 in 2012. Similarly, Greece's ranking on the various indicators of the World Bank's Easiness of Doing Business Project – that quantify investor protection, regulatory efficiency, government effectiveness, court speed, control of corruption, red tape - was low and falling over time compared to the OECD average. This pattern was particularly evident on measures proxying corruption, state capacity (bureaucratic efficiency), and the quality of legal institutions.

4.2. Labour Markets¹²

¹² Lyberaki, Meghir, and Nikolitsas (Labour Market Regulation and Reform in Greece, 2015) provide a thorough overview of labour market institutions in Greece at the beginning of the crisis and discuss recent reforms. The authors present some ideas for reform. Panageas and Tinios (Pensions: Arresting a Race to the Bottom, 2015) discuss the key issues of the Greek social security system.

4.2.1. Issues

The initial focus of the EAP was on labour market conditions and in particular on reducing wages and modifying sclerotic labour market regulations. This emphasis stemmed from the substantial wage increases since the inception of the euro (way more than in other euro area countries) and from the apparent rigidity of labour legislation.

4.2.2. Pre-existing Conditions

The Greek labour market on paper looked very rigid, characterized by sclerotic and formalistic institutions and numerous regulations. There were firing caps, restrictions on overtime work, the minimum wage had spillover effects to most workers (since depending on seniority and qualifications, their wages were tied to minimum wage movements), there was collective bargaining at the national level, the industry level and then at the firm level, and many other frictions. Moreover firms had to follow endless procedures and the system was very formalistic. Yet in practice the labour market was flexible, some might say anarchic, with the exception of large firms and multi-nationals (that had to obey with the rules, though even here there were abuses). This is because most Greek firms are family-owned and very small (usually with one to five employees); and the share of self-employment in Greece is the largest among the OECD countries. Given these features, labour laws were not particularly binding. Labour inspections were minimal, so in practice the laws were not enforced. Moreover, the shadow economy is very large. These features of the Greek economy also explain why the reform of the collective bargaining law had a limited impact, since it involved a small number of firms.

4.2.3. The Programme

In response to the crisis and pressure from the troika, Greece has reformed massively its labour market institutions, which at the origin of the crisis were deemed as business-unfriendly. Reforms were multidimensional, the most significant being the substantial reduction of the minimum wage (in both the public sector and the private sector), the decentralization of wage bargaining, and the severe relaxation of employment protection.

Reforms have been applied to four broad categories:

- i. Rights at work and retirement;
- ii. Equality of treatment;
- iii. Collective bargaining; and
- iv. Employment protection

After many legislative rounds, the institutions governing labour markets have been drastically modified. While it is challenging to identify causal effects, the economic downturn and the increased flexibility of labour markets have been associated with a massive decline of unit labour costs. The figures reveal that ULC-based REER has depreciated by 16.5% since 2009, though CPI-based REER has depreciated by only 5.6% since 2009.

Most of the participants agreed that increased labour market flexibility is beneficial only provided that trust and contract enforcement are preserved, demand policies are not overly contractionary, distortions in product and capital markets are simultaneously removed and adequate social protection systems are in place. But none of these conditions were met.

4.2.4. Assessment and Discussion

The evidence on the success of the reforms on the labour markets has been mixed. On the one hand, unit labour costs have fallen, considerably improving Greece's international competitiveness by this measure. On the other hand, when competitiveness is measured at final good prices then improvements have been modest (since due to the oligopolistic nature of product markets and red tape, price inflation was considerable during the crisis years). Perhaps most importantly, the lowering of labour costs does not seem to have brought much-needed investment, entrepreneurship and increase in employment. On the contrary, unemployment rose dramatically while there was a sizeable substitution of permanent contracts with temporary ones.

The discussion focused on the interaction between labour market reforms and other reforms such as liberalization of product markets, the modernization of the public administration and judiciary reform. Almost all participants agreed that labour market reforms should have been complemented by these other reforms. Moreover, many participants argued that the sequence of reforms (starting from modifying labour market institutions and then proceeding to product market reform) was wrong and has contributed to the severity of the economic downturn. This is because the interaction of sizable wage cuts with the liquidity squeeze and public expenditure cuts yielded large Keynesian effects. At the same time, if product market reform had been prioritized and implemented successfully this would have brought prices down, thereby mitigating the adverse impact of the drop of wages ("real wages would have dropped less than nominal wages, while during 2009-2014 real wage cuts were even larger than nominal wage cuts due to high inflation"). Participants also argued that historical experience suggests that labour market reforms affect the economy with a long lag.

4.2.5. Way Forward

Almost all participants argued that further labour market reforms are no longer necessary. Three specific issues were considered.

First, it seems that there is pressure from the troika to liberalize collective dismissals further. While this could help attract some large scale foreign direct investment, most participants argued that this should not be a priority. And given the political constraints and the anarchy in the Greek labour market, the troika should not push hard here, as government political capital is limited and declining. Perhaps the Greek authorities could commit on such relaxation once growth picks up. And perhaps relaxing firing restrictions for large firms could be assessed on an ad hoc basis if needed to attract large scale foreign direct investment.

Second, another controversial issue in the ongoing negotiations is the government's willingness to re-launch collective bargaining system and to aim at a system that will strike a balance between fairness and flexibility. Most participants argued that government's intention to liaise with the International Labour Organization (ILO) on this issue and come up with a moderate proposal is appropriate.

A third controversial issue was the government's proposal to restore a minimum wage at a level around 50-60% of the current median national wage. There was no consensus here, as opinions were split between those arguing for some modest rise – that would perhaps entail positive aggregate demand effects – and those arguing that the drop in labour costs is a significant achievement that could help the recovery.

All participants agreed, however, that future reforming efforts should focus on product markets, public administration, building state capacity and improving legal institutions and the judicial system.

4.3. Product Markets¹³

4.3.1. Issues. Greek Product Markets at the Beginning of the Crisis

One of the underlying reasons behind Greece's loss of competitiveness and the low levels of entrepreneurial activity has been the high degree of product market regulation and the associated high levels of red tape.¹⁴ Greek markets are characterized by numerous administrative barriers to firm entry in almost all sectors of the economy, complex regulations, price caps, and anachronistic

¹³ Katsoulakos, Genakos, and Houpis ([Product Market Regulation and Competitiveness: Towards a National Competition and Competitiveness Policy for Greece](#), 2015) provide a thorough overview of the key issues on product markets in Greece.

¹⁴ For example Greece's ranking on the "goods market efficiency" component of the Global Competitiveness Indicators has been always worse than its overall ranking. In the beginning of the crisis Greece's ranking was around 100.

licensing procedures; moreover state's involvement is strong in all industries yielding to corruption. At the same time land use legislation is arcane and property rights weakly defined. While in theory regulation can be welfare enhancing, in Greece it has been used to protect insiders, by shielding them from competition.

Greece scored quite low across various proxies of red tape (administrative barriers to entry) and product market regulation at the beginning of the crisis. For example Greece scored the highest across EU countries on OECD composite product market regulation that captures lack of competitive structures and red tape in 2008. Likewise OECD measures of restrictions and profit margins on key service sectors, such as law, accounting and food put Greece on the top of the EU. The comparative statistics of World Bank's Doing Business project reveal a similar picture. Greece's ranking on the easiness of starting in business in 2007-2008 was 152 (out of 178 countries).

4.3.2. Product Market Regulation Reforms during 2010-2015

Product market reform should have been a top priority of any programme aiming to modernize the Greek economy and increase its competitiveness. Yet the initial economic adjustment programme included very few interventions on product markets. And while the second economic adjustment programme (EAP) was much broader and detailed many specific measures on product markets, these provisions were not prioritized during its implementation.

At the design level, with troika's nudge, the Greek government undertook some policies aiming (i) to abolish bureaucratic barriers to entry and firm expansion; (ii) simplify the burden licensing requirements; (iii) remove geographic restrictions and other precincts that applied to many "closed" professions (e.g., lawyers); (iv) strengthen the Competition Commission so as to tackle cartels; (v) liberalize some key markets via privatization (e.g., energy, transportation); (vi) remove price ceiling and other related regulations; and (vii) standardize, harmonize and improve the chaotic regulations that applied in many sectors.¹⁵

Yet product market interventions were not well-designed (as they were developed in a hurry), were partial addressing in most times just a couple of the problems, and quite often their implementation was incomplete and ineffective (mainly through lower level regulation that was leaving too many exceptions). Severe opposition from vested interests and lack of political commitment impeded product market reforms. Moreover, the implementation of these reforms

¹⁵ In this regard the Greek government seek the assistance of the OECD that produced comprehensive reports with very concrete policy recommendations on various sectors (see [OECD Competition Assessment Review](#), Greece, 2013; and [OECD Measurement and Reduction of Administrative Burdens in Greece: An Overview of 13 Sectors](#), September 2014).

appeared challenging in practice due to the weak state capacity of the Greek public administration that proved to be quite ineffective in designing and implementing some key structural reforms on many sectors.

However, it should be acknowledged and in spite of all these inefficiencies, for the first time in many years there is clear evidence of a slow, but steady improvement. All international indicators are now showing a reversal of the previous negative trend. Greece' position on the Global Competitiveness Index improved from 96 in 2012 to 81 in 2014. In the World Bank's Ease of Doing Business Greece overall index Greece went from 65 in 2014 to 61 in 2015 and in OECD Product Market Regulation Index Greece's score from 2.21 in 2008 went to 1.74 in 2013. OECD named Greece as a "champion in terms of reforms" in 2012. Yet, despite the significant progress, there is still significant room for improvement for Greece to regain its international competitiveness. Product markets continue to be heavily dominated by a few players and there are still many barriers to entry, both direct (procedures and regulations to start a business, register property, get permits to export) and indirect coming from an administration and legal system designed to protect "insiders" at the expense of "outsiders".¹⁶ What is particularly worrying is that the new government does not seem to believe in the process of increased competition through product market reform. For example OECD toolkit has been abandoned. Most of its initial interventions during the first five months and law changes are towards reverting to the old state of heavy government regulation rather than liberalizing the way of doing business.

4.3.3. Looking Forward

All participants argued that product market reform should be a top priority for the new programme. The Greek government should design and implement an ambitious, deep, and comprehensive programme to liberalize product markets, foster competition, remove barriers to entry and firm expansion, open up (still) closed professions, strengthen (rather than weaken) independent regulatory agencies, and proceed with privatization (for example of ports, regional airports, marinas). Throughout this process, particular emphasis should be given to help companies increase exports: modernise and streamline the export procedure through customs offices, strengthen quality standards and promote investment in strong brand names and help them explore new markets.

Product market reform is needed so as to enable Schumpeterian creative destruction and move the economy from declining –inward- sectors to export-oriented industries and sectors with rising

¹⁶ Another testament of the initial low levels of product market competition was also the slower adjustment of prices and the relatively high inflation rates of Greece during the first years of the crisis in spite of output collapse.

global demand.¹⁷ At the same time product market reform will raise firm entry, lower prices, and in the medium-term offer much-needed opportunities to the youth.

Building on previous efforts, the Greek government could collaborate with the OECD (and perhaps other international organizations) in this process; given the weak state capacity, the dysfunctional bureaucracy and the low morale of the public administration, and the constant cabinet reshuffles, it is hard designing from scratch a holistic comprehensive product market reform programme.

4.4. Legal Institutions and Judicial System¹⁸

4.4.1. Issues

The discussion then moved to public administration issues; since this is a very wide topic the discussion focused on the judicial system and legal institutions. There is ample research pointing out that strong legal-contractual institutions and a fast-proceeding and transparent court system matter crucially for productivity, entrepreneurship, creative destruction, financial intermediation, and also low levels of inequality. Yet the initial EAP entailed very few concrete measures on reforming the legal system. The second EAP was much more analytical entailing various concrete proposals. Yet again the implementation of these reforms was partial, reversed, and their impact has been moderate at best.

4.4.2. Key Features of the Legal System in the Beginning of the Crisis

Both de-jure and de-facto legal protection of investors in Greece was extremely low at the beginning of the crisis; as with state capacity and the quality of public administration, the situation had deteriorated considerably during the 1990s and 2000s. Let us quickly review the key characteristics of the Greek legal and judicial system. This will help to understand the pathologies of the Greek public administration more generally.

First, the quality of laws safeguarding property and protecting investors is very low. For example, as of 2008 on the World Bank's composite shareholder's rights index, ranging from 0 to 10, Greece scored 3.0, ranking 158-165 out of 181 countries (the world average was 4.87). Greece has the lowest score among all euro area countries, and its score was lower even than the mean of low-income countries. Creditor rights protection is also low. According to World Bank estimates a

¹⁷ See Ciccone and Papaioannou (2007, 2008) for a theoretical exposition and cross-country cross-industry evidence.

¹⁸ Papaioannou and Karatza ([The Greek Justice System. Collapse and Reform](#), 2015) discuss the key structural deficiencies of the Greek judicial system, the reforms of the past five years, and also provide a series of policy recommendations on dealing with the huge case backlog and on improving its efficiency in the medium-term.

typical insolvency in Greece takes 2 years, the highest across the EU. The recovery rate for creditors was less than 50 cents on the euro, again the lowest across Europe.

Second, legal enforcement from the court system is of low quality and in many cases absent; Greek courts are absurdly slow, procedures are formalistic, and court decisions are often unpredictable. According to World Bank's Doing Business statistics, in 2008 it took 819 days on average to resolve a relatively straightforward dispute, that on average the rest of the world resolves in 620 days. The comparison with other euro area countries is even starker, as there plaintiffs needed 507 days. The statistics of the European Justice Scoreboard (2013) reveal a similar pattern. On average it takes roughly 500 days to complete a legal dispute in Greece, while the median for EU27 is around 150 days. The differences are especially pronounced in administrative courts, where it takes years to resolve cases. As of mid-2014 there were more than 400,000 cases pending in administrative courts. For half of those cases, the date for the first hearing had not been set. And first hearings for cases filed at the First-Instance Administrative Courts of Athens are being listed for 2019. The situation in civil courts is not much better. If a claim were filed today at the First-Instance Civil Court in Athens it would be heard in April 2018 at the earliest (for claims between 20,000 to 250,000 euros) and in May 2016 (for claims exceeding 250,000 Euros). The conditions in criminal courts are also depressing, as some important felonies have been pending in courts for a decade. It is common for a trial to start after the maximum (18-month) period of custody has elapsed.

Third, the judiciary (as many public administration sectors) is highly inefficient, as Greek courts lack basic ICT infrastructure. Many judges and supporting personnel do not have access to personal computers, email, or even copiers. Until 2012 Greek courts were not even obliged to compile and submit to the Ministry of Justice basic statistics on the number of incoming cases, clearance rates, etc. And even nowadays there is no electronic registry of cases in all courts.

Fourth, there is considerable misallocation of labour, again a common feature of Greek public administration. While the number of Greek judges per capita is around the EU mean (perhaps somewhat higher), the share of paralegals, judge-like personnel, and judicial assistants is among the lowest in the EU.

Fifth, the low efficiency comes also from the high level of formalism, as there are very few specialized courts, and many disputes that in other EU countries are dealt by magistrates and judge-like personnel in Greece enter formal procedures. And since the appeal costs are trivial, it is quite common that disputes with minimal financial (or other) interest linger in (first- and second-instance) courts for more than five years. Alternative dispute resolution mechanisms, such as mediation and arbitration, are not widely used.

Sixth, while expenditure in the judicial system (as a share of total government expenditure or in per capita) terms is comparable to the EU mean, when one excludes salaries, the Greek system appears extremely underfunded. The ratio of salaries to overall expenditure of the court system across 29 European states is 66%; this ratio in Greece is 96%. This again applies much more generally in hospitals, schools, etc.

Seventh, as in other branches of the Greek public administration, there are very few checks and balances and accountability is depressingly low. The lack of computerization and the incentive and compensation structure is also not well-aligned for efficient monitoring.

Eighth, "insiders" (lawyers, judges, prosecutors) often oppose reforms. The fact that together with Italy, Greece has the highest number of attorneys per capita in the EU is not unrelated to the high degree of formalism and the endless procedures.

4.4.3. Reforms during 2009-2014

Many reforms were initiated during the past five years, of which quite a few came from Greek authorities rather than the troika. Examples include: (i) the introduction of the "precedent-model trial" that allowed grouping hundreds of pending cases (mostly on pension-related issues and disputes with tax authorities) and resolving them quickly; (ii) placing caps on adjournments (it was quite common for a hearing to be postponed five times); (iii) initiating an ambitious programme (E-Justice) to computerize courts and allow for the electronic filing of cases; (iv) moving many cases from three-panel juries to single-member courts (so as to increase clearance rates); (v) initiating new public prosecution offices for economic crime and establishing an anti-corruption special unit; (vi) increasing appeal costs somewhat by introducing a small fee; (vii) amending the bankruptcy code to close some loopholes; (viii) redesigning the system of alternative dispute resolution mechanisms (mediation and arbitration); (ix) modifying civil and penal procedure in an effort to reduce formalism; and (x) partially changing the administrative map of court jurisdiction that in some areas dates back to the era of King Otto, among others.

While some of these reforms did yield immediate improvements (most notably model/precedent trial, the cap on adjournments, and the movement of cases on single-panel bodies), conditions have still not improved to a satisfactory degree. Due to the crisis, the number of incoming cases has increased considerably; at the same time the government has been silently trying to avoid paying suppliers, thus pushing many firms to seek compensation via administrative courts; morale has fallen as wages have been cut; and the recruitment freeze has lowered the number of personnel, especially young professionals with much-needed knowledge of IT.

The reforms of the past years have failed to lead to a paradigm shift, because of their incremental nature, the massive opposition of insiders (attorneys, judges, and judicial personnel), weak state capacity, non-collaboration of the administration and the huge case backlog.

4.4.4. Looking Forward

Most, if not all, participants argued that judicial reform should be a top priority for the new Greek administration and the institutions. It is hard to have a robust recovery with (local and foreign) investment when the current system offers very weak protection to investors. A detailed, comprehensive program of legal and judicial reform should be a key part of any subsequent adjustment programme. Policies should be two-fold.¹⁹ First, it is vital to address the pressing problem of case backlog and to restore the normal operation of justice. This will raise the legitimacy and popularity of reforms. If Greek citizens see tangible improvements, then it will be unlikely that subsequent administrations will reverse course. The Greek government could perhaps recruit for a 3-5 year period lawyers as magistrates who will deal with the case backlog. Another option is to offer incentives to senior judges to retire at later ages. The troika could also approve recruitment of much-needed judicial personnel and para-legals (who can be law school graduates) who can help judges. Since the problem is mostly present in administrative courts, the government could try to close these disputes in out-of-court-settlements.²⁰

Second, a much wider medium-term plan to reform the judicial system is needed. Such reform must encompass every aspect of the system: the hiring and training of judges, the administration of courts, the infrastructure of courts, the provision of modern information and communication systems in the court system, the rules of civil, administrative and criminal procedure, the accountability of judges to the community, and the constitutional framework.

5. Banking System

5.1. Issues

¹⁹ Papaioannou and Karatza ([The Greek Justice System. Collapse and Reform](#), 2015) provide numerous recommendations both on dealing with the case backlog and for the medium-term. The Hellenic Confederation of Enterprises (SEV) has also recently (2014) provided a detailed set of proposals in reforming the legal system.

²⁰ The chaotic conditions in administrative courts are driven to a great extent by the non-payment of various debts by the government, state-agencies, and municipalities. In the overwhelming majority, the state's liabilities are explicitly acknowledged. According to some estimates, the state's verified outstanding liabilities to construction firms and pharmaceutical firms are close to 5 billion euros. Yet the government forces firms and individual contractors to seek payment by getting orders from courts and then utilizes the slow and formalistic procedures to delay payment. This practice has contributed to the liquidity squeeze.

The sovereign debt crisis in Greece had a dramatic impact on the banking system, as Greek banks experienced huge losses in their holdings of Greek government debt after the PSI in 2012. The credit crunch, the political and economic uncertainty, the associated deposit withdrawals and the poor economic performance of the Greek state tarnished the conditions for the banks even further. A huge recapitalization process took place after the Greek default in 2013. The latter changed significantly the landscape of the banking sector. While some improvement with the completion of bank recapitalization, the partial access of banks to foreign debt markets, and the stabilization of the economy in the first semester of 2014, political uncertainty led to a deterioration of the economy in the last quarter of 2014 and over 2015. Challenges still remain on how to deal with the growing amount of non-performing loans (NPLs). This is a pre-condition for restoring the credit channel that is holding back lending to the real economy.

5.2. Conditions at the beginning of the crisis

The Greek banking system experienced a credit boom after Greece's entry to the Euro area. Credit to the private sector increased from 71.6% of GDP in 1998 to 122.8% in 2008²¹. The increase in private sector loans was more noticeable for household loans. According to the IMF, private credit became the dominant stimulus from 2001 onwards. Private credit was 43.4% of the Eurozone average in 1998 and grew to 74% in 2008, a faster rate of growth than in all other Eurozone periphery countries. The fast growth of private credit was associated with an increase in riskiness of the Greek banking system: the "beta" of the Greek banking index with respect to a global index was higher than the Eurozone average, and below only that of Ireland, Belgium, and Austria.

5.3. The Adjustment Programme

While the exposure of Greek banks to sub-prime mortgages in the United States and other toxic assets was minimal, their health started to deteriorate at the very early stages of the crisis, as they were hit by the economic downturn (recession, spread of crisis in the EU periphery) and political instability. Moreover some Greek banks were affected by the crisis in Eastern Europe in 2007-2010. Yet these losses were clearly manageable. Liquidity problems came first, in late 2008. Solvency problems came after September 2009, when the sovereign crisis started.

When the sovereign crisis hit the Greek economy, the huge losses on holdings of Greek government bonds (GGB) rendered Greek banks insolvent. Greek banks were holding large

²¹ Haliassos, Hardouvelis, Tsoutsoura and Vayanos ("Financial Development and Macroeconomic Stability in Greece", 2015) review the conditions of the Greek financial system at the beginning of the crisis and the key developments over the past five years.

positions in GGB due to the historical home bias in the financial sector and also because the government put pressure on state-controlled banks to acquire and hold large quantities of GGBs. Moreover, anecdotal evidence suggests that the Greek government nudged also non-state banks to increase their holdings of GGBs during the early stages of the crisis; and some (smaller) banks seem to have entered a “carry-trade” strategy, investing in GGB that offered high returns during 2009-2011. In addition, the high exposure of the Greek banks in private credit made things even worse amidst an anaemic global financial environment. Banks’ liquidity concerns became life-threatening, and this forced the ECB and the Bank of Greece to use the Emergency Liquidity Assistance (ELA) of the Euro-system to finance Greek banks. While this liquidity injection was costly, with higher interest rates than the rest of euro-zone countries, it was the only possibility, as Greek banks ran out of the high-quality collateral that is usually employed in repo transactions. Consequently, the Greek banking system became an impaired channel for financing Greek firms. According to the Euro-barometer survey in 2009, 39% of the Greek SMEs replied that the most severe problem they were facing was access to finance. This was by far the highest percentage among EU countries.

This inadequate access to finance by Greek businesses led in turn to the slump of investments (that overall fell by 50% during the crisis). Moreover, the decrease in bank lending contributed to the economic slowdown hitting tax revenues. The recapitalization of the Greek banking system and the resolution of many small banks left four large banks holding the vast majority of banking-system assets. The Greek banking system is now the most concentrated in the EU. There is also no presence of foreign banks, as almost all foreign banks have exited (Credit Agricole and Societe Generale) or have reduced their presence (Citigroup and HSBC). Another important characteristic of the Greek financial system is the minimal presence of other types of financial institutions like insurance companies and large investment funds.

5.3.1. Successes

One of the main achievements of the two Economic Adjustment Programmes was the recapitalization of the Greek banks and especially the transition from a situation where all banks were insolvent to one where banks’ solvency was restored with significant inflows of new private capital. According to the plan (Report of the Recapitalization and Restructuring of the Greek Banking Sector, Bank of Greece, December 2012) Greek banks would be recapitalized and sold off to new private owners. A target level of 20.1 billion euros was set for Core Tier I capital for the aggregate banking system as of the end-2014. Because bank capital net of losses in GGB and other loans to the Greek state, as well as projected losses in private-sector loans, was negative and estimated at -20.4bn, a capital injection of 40.5bn was necessary. Private investors could not come

in at a loss, so public funds were required. These entered as a 50 billion euro loan from other Eurozone countries. To induce private investors to come, it was necessary to offer them better terms than the state, and this was accomplished through warrants offered only to private investors.

5.3.2. Problems and Pending Issues

Greek banks have been severely hit by capital flight anytime uncertainty emerged over a bail-out agreement between the troika and the Greek government. Between 2010-2012, Greek banks lost about 30% of their deposits. It is striking that in the first five months of 2015, Greek banks lost a further 20-25% percent of their (already depleted) deposits, as rumours of capital controls and a Grexit started to spread. The only difference in the withdrawals of this year is that most of the money has not gone out of the country but stayed within as cash or short-term investments.

The growing amount of NPLs is another major problem. According the BoG, as of the first quarter of 2014, NPLs (including restructured loans) were 93.2bn, provisions of NPLs were approximately around 37.6bn and capital was 27.8bn. These numbers accounted for 40.3% of all loans. If we exclude the restructured loans, NPLs accounted for 33.4% of all loans, with their total value at 77.3bn, of which 12.3bn were consumer loans (49.2% of all consumer loans), 18.3bn were housing loans (27.3% of all housing loans), and 46.7bn were corporate loans (33.6% of all corporate loans). Thus maintaining solvency and capital inadequacy has become a main challenge of the Greek banking system.

The NPL problem is exacerbated by two main reasons that have to be taken into careful consideration when designing the new programme:

- Bank managers' lack of flexibility, due to state ownership. As the Greek state became a large shareholder in all banks after the recapitalization, the managers are now exposed to lawsuits alleging mismanagement of public funds. The penalties they face if convicted of fraud and embezzlement may be life imprisonment. Thus managers are highly reluctant to reduce the debt of firms even if this would make sense in economic terms.
- Greek banks may need to adopt an extend-and-pretend strategy that implies a roll-over of a firm's debt even if a firm is clearly unable to repay. This strategy is currently attractive for bank managers, as it does not force banks to take capital losses, so they are not required to raise fresh capital to meet the capital ratios. This strategy is quite important for banks that have low capital ratios and are close to the regulatory cut-offs. As the true core capital of Greek banks is quite close to the regulatory minimum, the problem of extend-and-pretend is likely to be relevant in practice.

In both cases, levered firms are steadily transformed into "zombies", operating inefficiently, and will end up being liquidated at values below those that would have been achieved without all the delays and depreciations. Moreover, banks themselves are transformed to zombies, as their priority is not giving new loans or restructuring their portfolio of NPLs but simply waiting for a miraculous rebound of the economy. The example of Japan suggests that zombie banks and firms can be a huge drag on recovery and can prevent the efficient reshuffling of the economy.

5.4. Looking Forward – Discussion

The participants discussed in detail many policies that could address the pressing needs of the Greek banking system in an effort to restore credit and liquidity.

5.4.1. How to tackle NPLs and the extend-and-pretend: increase provisions

One way to deal with the problem of “extend-and-pretend” is to ensure that the banks hold sufficient amounts of provisions against the NPLs they have in their portfolios. These provisions have to take into account realistic estimates of the losses that might occur from NPLs. This strategy will not transform the indebted firms into zombies, and the creditor banks will not suffer any more reductions in capital except for those imposed by the regulator in order to increase the level of provisions.

Another key issue is whether establishing an asset management company (AMC – a “bad bank”) to deal with NPLs would be appropriate for Greece. An AMC has important advantages and has worked well in other Eurozone countries, such as Spain.²² Advantages from creating an AMC are:

- Incentives for loan resolution are better because the AMC managers were not the ones who made the bad loans and are hence less conflicted when sorting them out.
- There are no incentives to pursue an extend-and-pretend strategy.
- There are economies of scale (and scope) in resolving bad loans

On the other hand, there some notable disadvantages:

- Significant private funding is required, and it is not clear where this can come from. One idea is to use the 10-11 billion euros that are in the ESM initially intended for bank recapitalization. Yet this amount is perhaps insufficient; given the scale of NPLs, more funding is needed. One idea is to attract private money from specialized hedge and private equity funds. Another is to

²² Most participants agreed that if Greece were to proceed with the establishment of an AMC, this should include NPLs of the full banking system. So the eleven “bad banks” formed by the resolution of banks during the recapitalization process should be merged so as to realize economies of scale and scope, increase transparency and monitoring.

get additional funds from the ESM-EFSF. It is crucial here to raise private equity capital, however, so that the AMC is run by independent, private sector managers and personnel, avoiding state interference. It may be also worthwhile to involve the ESM directly in the management of the “bad bank”.

- There is a risk of political interference and lack of commitment. This was a concern of many participants, who argued that an AMC might be under severe political pressure, creating additional problems in the Greek banking system (which has traditionally suffered from political interference). There was concern for the limited institutional capacity of the Greek state to establish independent agencies. Moreover, in the past the government and politicians had interfered in the bankruptcy of dozens of state-enterprises that were liquidated and sold off in the late 1970s, 1980s, and early 1990s.
- To resolve loan conflicts in the courts may take up many years. Legal amendments are required, and courts have to act quickly. Given the dire situation of the Greek judicial system there is, therefore, a significant legal risk. This of course is a major problem independent from whether the AMC is created; yet the establishment of an AMC requires passing high-quality legislation. Given the present chaotic conditions in courts, one should perhaps try circumventing them (e.g., by relying on alternative dispute resolution mechanisms or specialized courts and tribunals).

5.4.2. A Development Bank?

The Greek government has been considering establishing a Development Bank. The key objective would be to provide Greek SMEs with improved access to investment loans and working capital to help foster investment and bring down unemployment. Several participants argued that such a bank is not needed and that it would be better to rely on the improvement of existing institutions.

Moreover, some participants raised concerns that a Development Bank would be subject to political interference and would thus have little impact. Others proposed setting up alternative schemes to channel funds to the economy such as the “Institution of Growth” in Luxembourg²³.

5.5. Way Forward

The Greek government must create the conditions necessary for further financial development.

There must be a strategy for maintaining solvency and capital adequacy through implementation of restructuring plans for the Greek financial system. Moreover, the right channels have to be

²³ The Institution of Growth in Luxembourg is an equivalent to a Development Bank. This institution would be an umbrella fund with three different sub-funds founded according to their specific promotional purpose: one sub-fund that would provide credit to Greek SMEs, one sub-fund that would provide equity capital to Greek SMEs, and one sub-fund for financing infrastructure projects.

established to ensure adequate liquidity for the real economy, especially for the SMEs. The system has to develop effective internal controls and risk assessment mechanisms. The aforementioned can be achieved by enhancing corporate governance, transparency and accountability. Therefore, almost all participants argued that a clear separation between the banking system and the state is needed. All advocated the design of a stable long-term arrangement for dealing with the NPLs. This may involve keeping things as they are but forcing banks to take more provisions, or creating an industry-wide bad bank. It is also essential to improve the judicial procedures for bankruptcy and debt restructuring. It was stressed that all of these recommendations require a formal proposal, lacking which the banking system will collapse. The banking system will be hit severely if an agreement is not reached and the Greek state defaults.

6. Conclusion

Greece needs an agreement now with the troika. The game of ‘chicken’ must stop now. All parties should end the “extend-and-pretend” strategy of the past five months that has led to massive uncertainty and has destabilized the weak economy. No solution is possible without an ambitious well-designed reform program. A lasting deal is needed; the new deal will need to address both the immediate short-run (mostly financing) needs of the Greek state and (most importantly) tackle the deep deficiencies of the Greek economy - a dysfunctional public administration, oligopolistic product markets, red tape, weak state capacity, poor protection of investors, absurdly slow judicial process. But realism must prevail. Greece is not solvent. Therefore mechanically setting a primary surplus target in relation to an arbitrary objective in terms of debt level will be self-defeating. We advocate that the objective in terms of deficit now be set in relation to the current state of the economy – a new slump and uncertainty.

Greece should agree to target a tiny symbolic primary fiscal surplus for 2015 and then gradually increase it in 2016-2018, as growth rebounds. As for the debt, we believe that before any negotiation on this issue is reopened, the Greek government needs to credibly show commitment to a reform plan. Restructuring and reprofiling of debt of the official sector with some drop in interest cost by further increasing maturities was agreed at the 27 November 2012 Eurogroup, but not implemented. This should be again on the table once confidence between the new government and the troika is restored.

This report stresses that the focus of the new programme should be on structural reforms, mostly product markets, public administration and the judicial system. Given the sizable drop in wages and the deregulation of labour market institutions over the past years, further liberalizing the labour

market should not be a priority. In contrast, the Greek government needs to reform the very expensive pension system that is both inefficient and unjust. All these reforms need to take place with Greece in the euro area.

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