

The Greek Tragedy and Its Solution



by Michael Bernegger

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Introduction and Summary

This article contains a counter-consensus analysis of Greece's economic crisis. A complementary background text substantiates the article's main statements in detail.¹ Attached to the background text are many informative graphs and tables, which are omitted here for reasons of space. Here are the article's essential arguments in summary form. A longer version in German is available at <http://j.mp/Bernegger>.

The Troika's Policy Towards Greece Is Based On A Fatal Statistical Error

Ostensibly, the Greek crisis is about sovereign debt. It appears to result from a too expansionary fiscal policy and a loss in price competitiveness since the launch of the euro. This competitive weakness, it is claimed, can be attributed to an excessive rise in labour costs in relation to anaemic macroeconomic productivity growth. Greece is seen as internationally uncompetitive because the economy's internal structures do not allow for or support any industries that can compete at that level. Bureaucracy, dysfunctional regulation, especially in the labour market, excessively high wages and costs are said to be the main structural obstacles. Hence, apparently, the periodic disturbances that since 2010 have been leading the country, in ever shorter intervals, to the brink of national bankruptcy. Hence also the strict austerity and deflationary programme that the troika has imposed on the country since 2010.

In reality, the core process is completely different: Greece is a country with very large and competitive export industries. Its merchant fleet has been the world's largest and most efficient since the 1970s. Its tourism sector enjoys a very strong position within Europe. In the 2000s, it developed successfully from mass to quality tourism, at very competitive prices in the upper and particularly in the top price segments. The country experienced an export boom from 1999 to 2008. No other country in Western Europe, with the exception of Norway, achieved even remotely comparable export growth. Owing to conceptual errors in the calculation of the balance of payments and gross domestic product, the export boom was recorded as a growing current account deficit and sluggish GDP growth. In truth, up to 2008 Greece achieved high and steeply increasing current account surpluses, more so than Germany did. That export boom was driven primarily by merchant shipping, the country's dominant economic sector since the 1960s.

Greek economic statistics are distorted, for conceptual and political reasons, in serious and obvious ways. This is shown in the (above-mentioned) background text for the two main export industries, merchant shipping and tourism. Balance of payments statistics for both

those industries are collected by the Bank of Greece. Merchant shipping specifically is conceptually misrepresented in Greece's balance of payments statistics since its return to Greece in the 1960s; in other words, for more than 50 years. That has to do with its currency exposure, the regulation and taxation of the sector in Greece, as well as with the country's monetary policy regime up to 1998. The problem has been globally known since the 1980s as the "missing fleet phenomenon", even seriously distorting current account balances worldwide, not only Greece's. Unlike in the rest of the world, in Greece, shipping companies' freight earnings from abroad were not reported as merchant shipping exports. The reported exports comprised only the transfers to Greece from the dollar accounts held by the shipowners abroad. These so-called remittances covered only domestic factor costs - seafarers' wages, salary payments including the NAT state pension fund in Greece, domestic inputs, company earnings and dividends paid in Greece.

All merchant shipping earnings are denominated in USDs (formerly also in GBPs), because that is how freight rates are posted around the world. The earnings were made exclusively to the shipowners' dollar accounts abroad because from 1932 Greece had a capital controls regime that did not allow any international capital transactions. The shipowners made their big payments - such as for the purchase of ships, the amortisation and interest on shipping credits, the purchase of fuel, operating expenses such as port and canal fees, labour costs for non-Greeks - exclusively from their overseas dollar accounts. On entry into the euro, the statistical coverage of merchant shipping in Greece by the central bank was improved superficially. The payments received by Greek banks are fully recorded, which was not previously the case. Also, a part of the overseas freight earnings started to be effectively recorded on accounts in Greece. That was a condition made by Greece-based banks for the ample loans they granted to the shipowners after the introduction of the euro. The percentage of merchant shipping export earnings covered by the official Greek balance of payments thereby increased from approximately 10% in 1999 to about 25% in 2008. But most of the sector's exports remain statistically unrecorded. The Greek central bank is reluctant to act, and merely distributes annual questionnaires regarding the shipowners' turnover under foreign flags, which the shipowners can fill in as a self-declaration. To a lesser degree, similar conceptual problems in statistics exist in the tourism sector. The practice there was changed to a new system on the introduction of the euro, the Frontier Travel System (FTS). But the system is unable to detect qualitative changes, like the spectacular expansion of five-star hotels in the 2000s.

Greece's export industry is very competitive, and it is oriented towards the world economy's above-average growth sectors and is consequently well positioned. But it is insufficiently diversified and, above all, concentrated on an extremely cyclical sector, merchant shipping. Since 2008, it has been exposed to an extreme sectoral price decline, which is hitting all operators hard. The same sequence as that of the 1970s and early 1980s is being repeated: Strong, synchronised growth of the global economy, a sharp increase in freight rates, large

orders for very big ships (early 1970s; second half of the 2000s), then the first oil shock (1973; 2007-08), then the second oil shock (1979-80; 2011-14), sharp downturn (1981-85) in the demand for seafreight and high overcapacity combined with a collapse in freight rates. For tankers, the average freight rates were in 2014/15 about 30-40% below the average rates in the 2000s, for bulk cargo transporters about 70-80%. Compared to the peak levels of 2008, the declines were as steep as 50%/95%. Also in the hotel and restaurant sector, prices have dropped by about 20% from 2007/08 levels. The contraction of Greek exports is a cyclical, sectorally-determined slump. No other country has, due to its specialisation risks, suffered such a serious exports collapse. Nevertheless, in those two industries, Greece has, already in the expansion phase but also during the downturn since 2008, clearly strengthened its international competitiveness. However, as an economy, Greece is seriously weakened.

An extremely deflationary foreign trade price shock ...

What initially brought Greece to its knees was an extremely deflationary price slump in its foreign trade. Not only for its merchant fleet, but also for the Greek economy as a whole, the two oil shocks of 2007/08 and 2011-14 represent enormous burdens. In the 1990s, Greece spent annually about 1% of its nominal GDP on its oil bill (net energy imports minus energy exports). In the years 2006-14, that percentage rose to an average of about 4% of nominal EDP-GDP. In the peak years, the percentage even exceeded 5%. In addition, there are the fuel costs of the merchant fleet, which is refuelled around the world and hardly ever in Greece. That expenditure is recorded not in the Greek trade balance, but in its services account as imports (intermediate inputs) of shipping services. That amounts to another 2-3% of nominal EDP-GDP. If all the freight earnings of Greek shipping companies were correctly recorded, instead of just a quarter of them, the actual energy bill would rise to about 15-20% of the correctly calculated nominal GDP.

No other advanced economy depends as massively on the price of oil as Greece does. This dependence reflects the country's maritime exposure. Greece has several thousand islands, many of them tourist destinations reached by ship or air transport, which means high transport costs. Electricity and heating are produced on the islands exclusively through oil/gas combustion in thermal power plants. Greece also possesses the world's largest merchant fleet. The fleet's fuel expenditure represents the largest part of the costs for voyages and - in oil shocks - even the total cost. What hit Greece massively, like no other economy, is a double price shock in its foreign trade. A price collapse in its export prices since 2008 and, parallel to that, a price explosion in import or input prices. Hence the extreme deflationary pressure from the foreign trade sector. The Greek central bank's official current account figures therefore present a false picture because they cover freight earnings and energy expenditure only to a small extent, as we have seen.

Correctly calculated, there was a rising current account surplus from 1999 to 2007/08 and a squeeze in the surplus and even deficits since then. The official current account shows exactly the opposite of the actual development, with disastrous consequences for the interpretation of the economic problems and the formulation of policy responses.

In essence, it's a case of a cyclical foreign trade price shock, identical to that of the early 1980s. It started in 2008, after Greece's terms of trade had previously been extremely favourable for the country's current account. It is exactly the same constellation as in the early 1980s: a collapse of freight rates combined with the second oil crisis of 1979/80, which then lasted until 1985. It's a classical terms of trade shock, which has nothing to do with Greece's internal price and cost dynamics. For these products, or rather services, Greece is a pure price taker. In the 1980s, Greece's policy responded in a, in principle, proper manner; namely, with an expansionary fiscal policy. That prevented, in the 1980s, a slide into a deep recession or depression. What was wrong then were two things:

- Labour market policy and pay determination in the core sector, merchant shipping. Sharply rising Greek seafarers' wages, due to the wrong choice of the reference currency for wage payments after 1977, led to a dramatic loss of seafaring jobs in Greece in the first half of the 1980s. That had grave consequences for shipowners' remittances and the then current account, and brought a drop in the Greek Drachma.
- The fiscal expansion was not applied as a temporary, cyclical policy measure. It was continued unchanged under different cyclical conditions and paved the way for cronyism-led party politics, with the well-known consequences for budget deficits and growing government debt.

The state of official data and the prevailing analysis of the growing current account deficits since the introduction of the euro are incorrect. Equally wrong is the claim of insufficient productivity gains, and, even more so, that of excessive wage cost increases. On the contrary, from 2003 to 2008 wages increased insufficiently in relation to the actually achieved productivity gains. Real wages, measured correctly, declined already during the upturn, although the economy was experiencing Western Europe's biggest boom. Also, the budget deficits and the level of government debt relative to actual GDP were not nearly of the order of magnitude reported in the EDP procedure. Correct is only that the balance of payments data published by the Greek central bank, and, derived from those, the national accounts data support the interpretation of increased unit labour costs and excessively expansionary fiscal policy, superficially, from a highly aggregated perspective.

... is aggravated by a misguided policy of internal deflation ...

Consequently, the troika has formulated an incorrect response: namely, a massive and historically unprecedented internal deflation in response to an external deflation of rare magnitude, in a small open economy. The concept of internal devaluation, as it is called, is inappropriate for several reasons:

- Greece's export industry does not benefit from massively lower wages and prices. That has to do with its structure. Earnings and expenditure by merchant shipping, by far the largest export industry, are, as we have said, almost exclusively dollar-based and have little to do with Greek factor costs. Shipping companies now employ, in contrast to the situation at the beginning of the 1980s, very few Greek seafarers. The bulk of the seafarers are Philippinos and Indians, who are paid in their home currencies. The merchant fleet is, moreover, extremely capital and barely labour intensive, in contrast to its structure some decades ago. In the tourism sector, many of the export-oriented firms are family enterprises with a low intensity of non-family employees. The bigger firms among the five- and four-star hotels are, by contrast, correspondingly more capital intensive. For the expansion of the five-star hotels, wages were no obstacle, on the contrary. In both areas, cheap, clandestine work by undocumented immigrants is in any case a significant form of employment.
- The internal devaluation policy does not take into account the former strong credit expansion and debt levels of private households and companies. Through lower wages and prices, as well as through high unemployment, nominal incomes are reduced. With unchanged outstanding debt to the banking sector and to the state, the current burden of interest, amortisation and tax payments as well as the value of outstanding debt continue to rise in real terms. Thereby, a debt deflation situation has emerged.
- This debt deflation is massively aggravated by the systemic banking crisis, which acts as a financial accelerator of the economic crisis. With the supposed 2010 sovereign debt crisis a withdrawal of foreign interbank deposits began, which brought about a credit stop by the banking system. The troika unwittingly intensified that process. Monetary policy became ultra-restrictive because the banking system's own capital was temporarily destroyed by the 2011 troika-imposed cut in debt. Since then, that capital has never been adequately built up again. Owing to that credit event, the banks immediately had to make extremely high write-offs. That destroyed a large part of their capital. The recapitalisation came, but only belatedly in 2012 and 2013. Meanwhile, owing to the massive reduction in their risk capital, the banks had to suspend their lending. The total credit stop made construction investment plunge to almost nil. The liquidity crisis stemming from the banking system spread to large parts of the real economy and

drove tens of thousands of companies and households into bankruptcy and cost hundreds of thousands of workers their income. As a result of the general liquidity crisis, there was a surge in banks' non-performing and bad loans. Those loans need to be backed by much higher own resources, so that the banks, even after the belated recapitalisation, have been unable to emerge from a situation of insufficient equity or risk capital. The massively deflationary policy exercised via the banking system lies, along with the foreign trade price shock (plummeting export prices with surging oil prices), at the heart of the Greek crisis. The temporary destruction of the banks' equity capital triggered a systemic banking crisis, which is reflected in an almost total credit crunch and a liquidity crisis paralysing the whole economy.

- The role of fiscal policy in the crisis is overemphasised or not appropriately assessed. True, a consolidation was needed. But the priorities were badly chosen by the troika. Fiscal consolidation was not only too abrupt, it also had extremely negative, distorting effects on the economy. Those who had up until then been paying taxes – regularly employed employees and households – now pay much more and receive fewer state benefits. The combination of the taxation measures – especially the sharply increased value-added, income and profit tax rates – and the spending cuts has massively increased tax evasion incentives. Those who had up until then paid little or no tax therefore still pay none or too little. Certainly, many of the self-employed and many firms can no longer pay because of the economic situation. Without causing such economic damage, it would have been relatively easy to get hold of considerable amounts of evaded taxes on the offshore accounts parked overseas.

... which leads to a debt-deflation spiral

Accordingly, this article describes the crisis as a debt-deflation spiral: to the external debt deflation in the economy's most important sector, merchant shipping, the internal devaluation policy adds an internal debt deflation and sets off a comprehensive and cumulatively intensifying process of macroeconomic debt deflation. The four characteristic elements are: the destruction of the banking system's equity or risk capital; plummeting real estate and ship prices, the principal sources of collateral for bank loans; steeply rising bad loans; and periodic deposit withdrawal panics in the banking system. The banks can no longer make loans, plunging the economy into a full-scale liquidity crisis. The banking crisis acts as a financial accelerator of a cumulatively worsening economic slump. Debt deflation consists of sharply falling nominal incomes and prices with unchanged nominal debt owed to banks and rising nominal debt towards the state. Interest rates and the tax burden rise dramatically in real terms due to the collapse of nominal incomes, making debt and debt servicing unsustainable. The government's manifest debt crisis reflects only one element of a much more basic process of full-scale debt deflation.

Given this analysis, at the end of the article, the major policy options are discussed, and both an exit from the euro and a continuation of internal devaluation are rejected. The exit from the Euro would harm merchant shipping and tourism, the two most important export industries. For the Greek shipping industry, devaluation would not be useful at all, as revenues and costs are both mainly dollar-based. Both industries are highly capital-intensive and require low and stable interest rates as well as sufficient credit supply. A return to the drachma would imply high and volatile interest rates with a high and time-varying risk premium. The best growth potential for tourism is in the four- and five-star hotel segment which both require continuously high investment spending as well. Only by sticking to the euro and with a banking system offering credit supply and low and stable interest rates can these two industries fulfil their potential. But to get there, a complete break with the current stand-off and policy approach will be needed. Acting swiftly and forcefully is required in order to prevent a bank-run and a collapse of the economy.

The focus is not on reform measures of the current type, but also not on selective social policy or fiscal measures. Instead, the banking system must be recapitalised immediately and the credit mechanism restored. That is the only way to alleviate the country's catastrophic liquidity crisis. On its own, a further financing of the public budget will not suffice and continuing the troika's "reform course" will only aggravate the debt deflation. The main policy points proposed concern: injection of equity into banks, the transfer of non-performing and bad loans to a properly designed "bad bank", the abolition of withholding tax on interest rates on domestic bank deposits, and changes in the regulation of merchant shipping. Only if the shipowners hold large part of their liquidity in Greece, instead of in overseas offshore accounts, should they be allowed to retain their tax privileges. This is the sole way to restore a sufficient deposit base in the banking system. Such deposits are imperative in order to achieve the potential for credit capacity to be restored.

¹ The background text can be requested from the author at michael_bernegg@gmail.com

Michael Bernegger is a Swiss economist with professional experience in central and commercial banking as well as in insurance.

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