Options, Decisions and Implementation under Extreme Market Conditions: Economic policy in Greece the day after

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Presentation

- ➢ Introduction
  - ✓ Self interested reaction or collaborative behavior
  - ✓ Crisis in the periphery illiquidity and all its friends
  - ✓ Issues to be discussed
    - o Stylized facts
    - o Theoretical explanation
    - o To stimulate or not to stimulate
- ➢ Stylized facts
  - ✓ Twin deficit budget and current accounts
    - o A long history for public debt
    - o Public finances and the history of revenues and expenses
    - o Current accounts and low productivity vs cost

Introduction

- Financial panics and cash flow inefficiencies
  - ✓ The theory behind. Explaining a tail event
  - ✓ The economics of contagion
    - Regulatory evasion
    - Mutual monitoting
  - ✓ Too interconnected to fail
- To stimulate or not to stimulate
  - ✓ A trade-off between stimulation and risking bondholders confidence
  - ✓ Defaulting or running a primary surplus and how much
- Concluding remarks

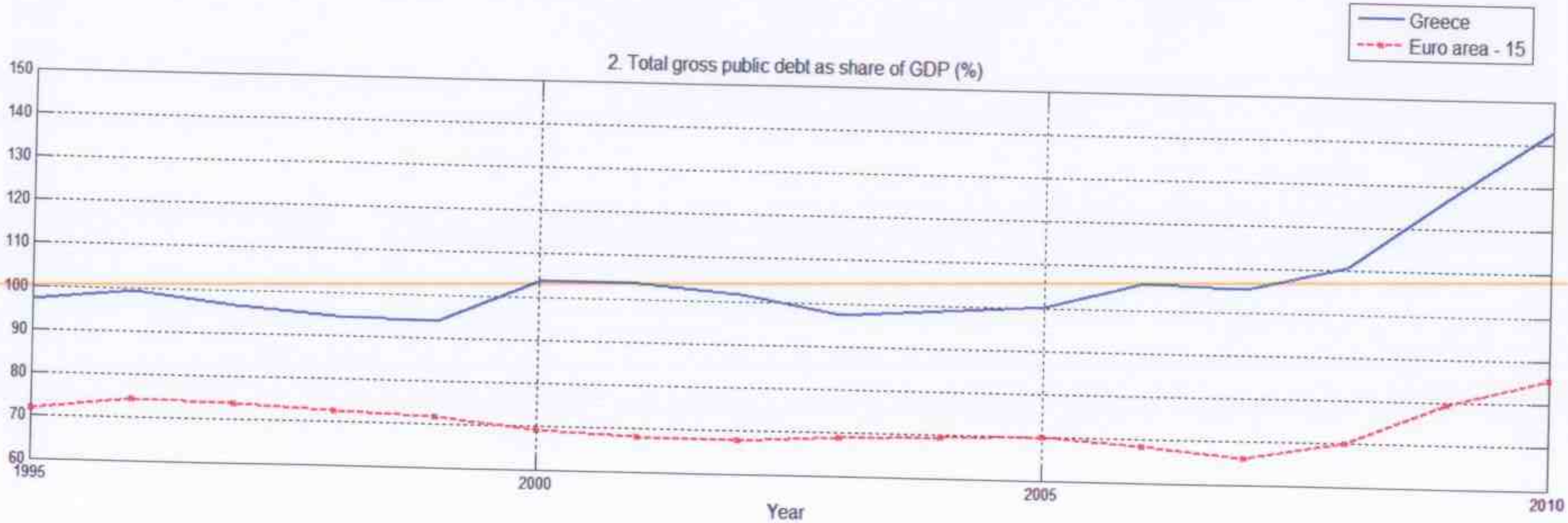
- *From a theoretical point of view this analysis shows that in such extreme cases, social cohesion disappears and self-interested reactions predominate. Counterfactually, prudence and collaborative behavior among individuals or members of a community is the safest exit from an incidence of social upheaval. In real life however, it is easier to say than do.*

- *It is the purpose of this paper to show that economic policy options as well as decisions are not straight forward, if we are asked to implement them on a crisis. In the case of Greece, tense financial situations, the speed of global deleveraging following the economic crisis, fears of contagion from and towards other Eurozone partners, persistent local deficiencies for example in tax collection and some delays and capacity problems in delivering complex structural reforms appeared much stronger.*

- *We claim that in order to meet its current liquidity shortfalls Greece should count on both funding and market liquidity.*

- *There is one common theme to the vast range of similar crises. The excessive debt accumulation imposing systemic risks during a boom.*

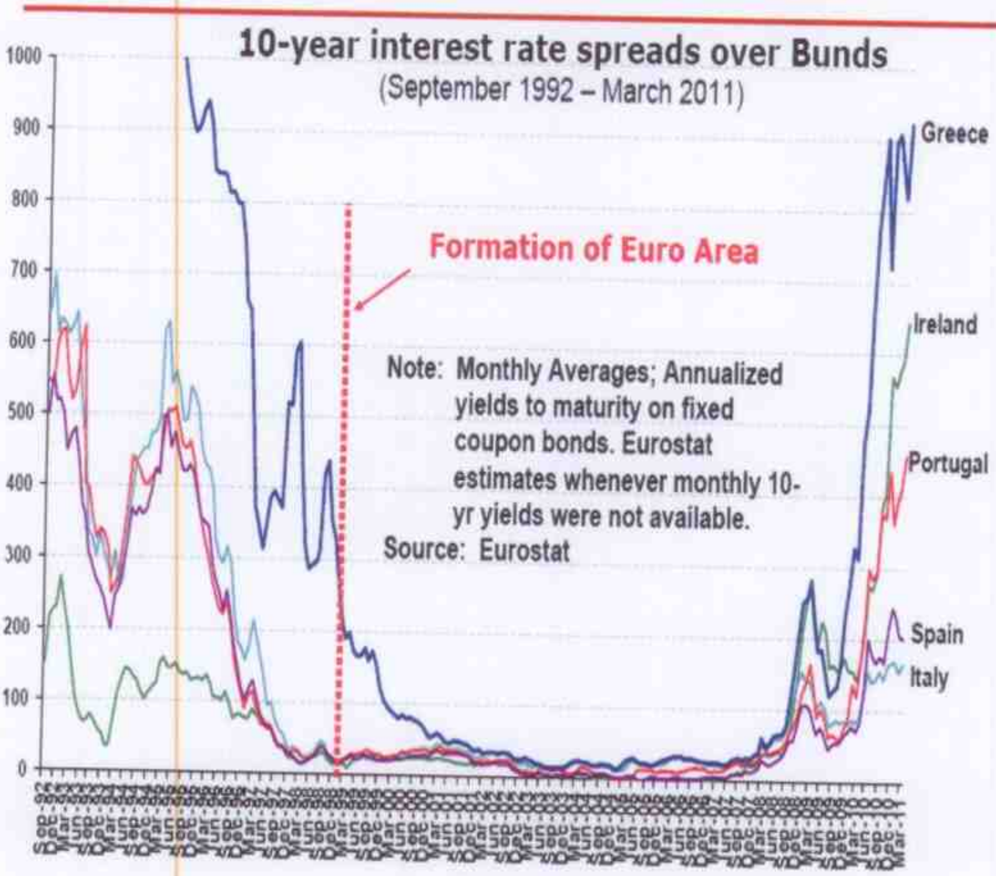
Total gross public debt as share of GDP (%)



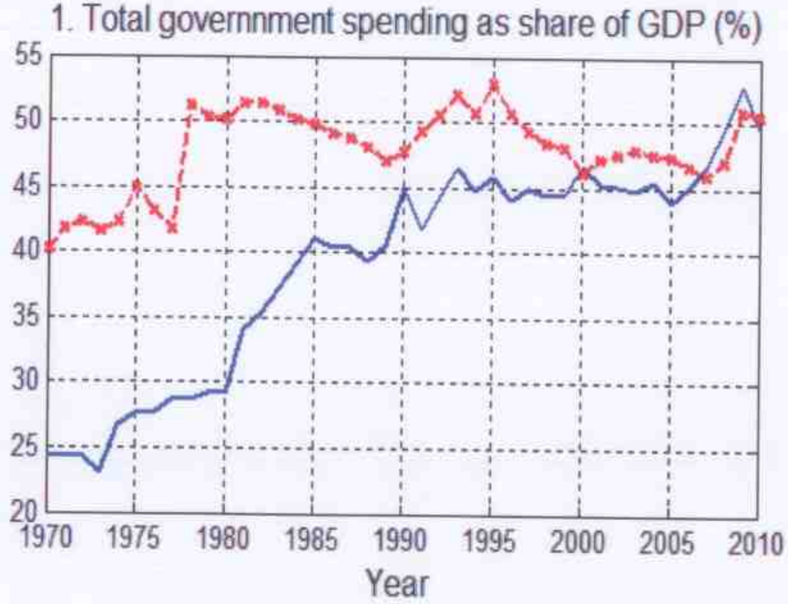
Stylized facts for Greece

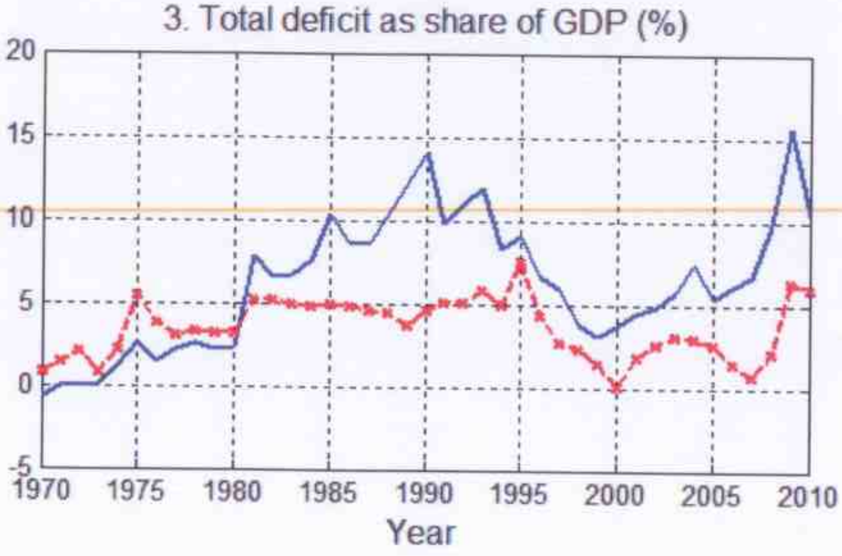
- Reinhart and Rogoff
- How unsustainable was the ussunstainable Greek fiscal path
- the twin deficit problem
- First public finance and total governement spendings
  - ✓ During the observed period total government spending as a share of GDP escalated from about 24% in the early seventies to about 50% - catching up the Euro area average – in the last years.
  - ✓ Total tax revenues respectively increased from about 20% to 33% remaining 10 percentage points below the Euro average.
  - ✓ As a consequence of the above the total government deficit was an ever present feature of Greek public finance (the first out of two Deficits). Under period of observation the share skyrocketed from 20% in early seventies to 150% presently. During the last fifteen years was 35-67% higher than the Euro average. A remarkable feature is that a substantial portion of it has to come from sources not included in the deficit (guarantees). Unlike other countries a considerable amount was held by foreigners.

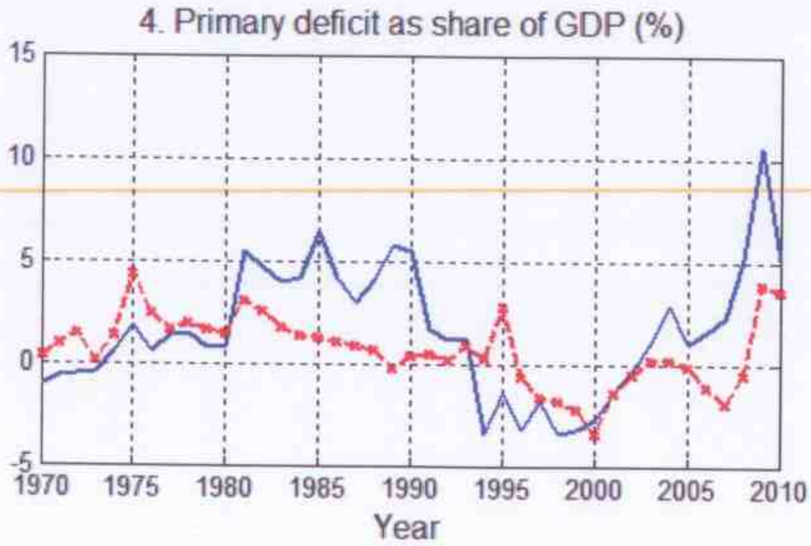
Markets woke up to Euro Area imperfections



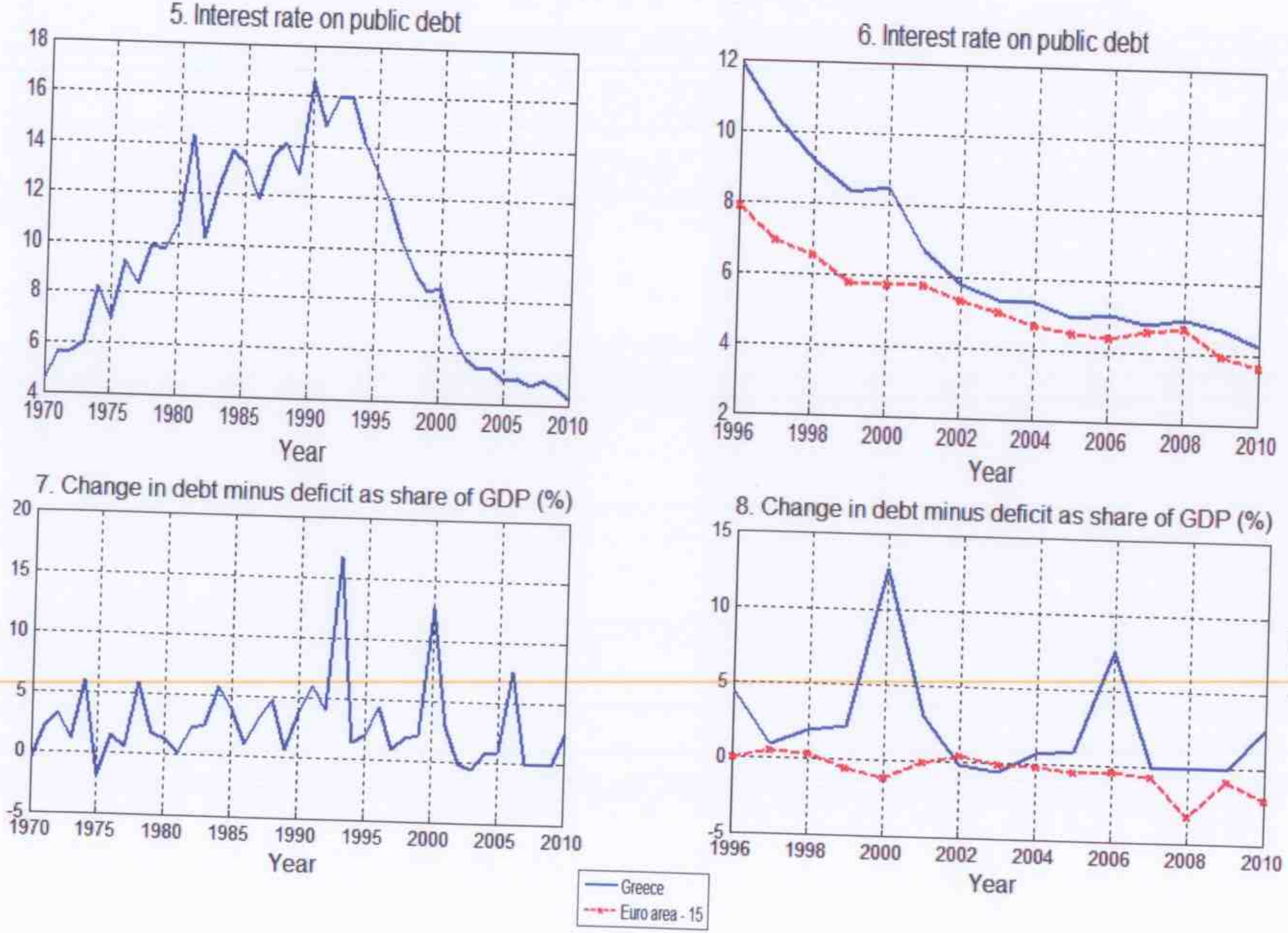
Public finances



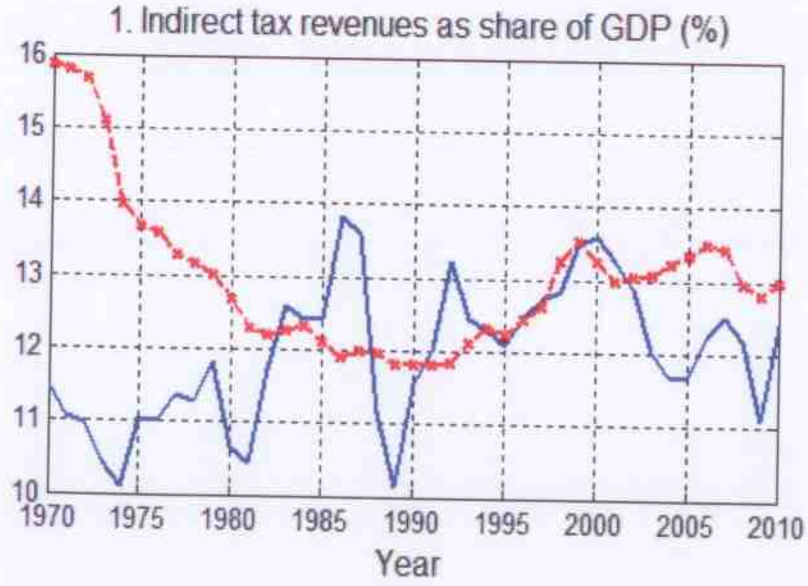




Public finances

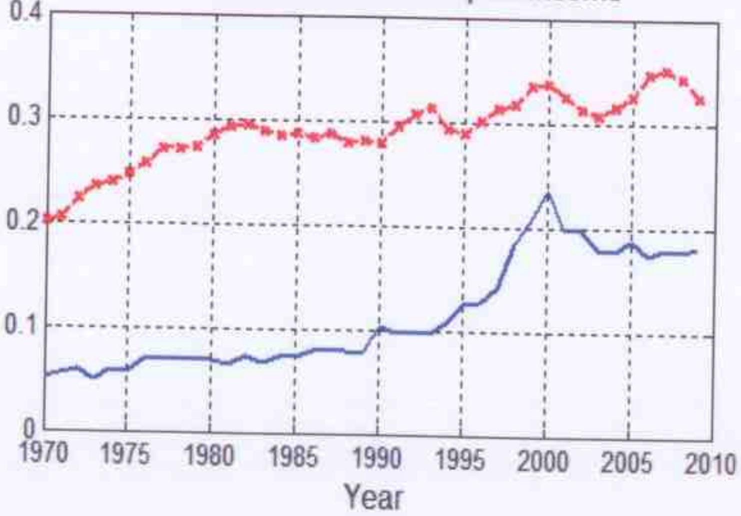


Tax revenues and effective tax rates

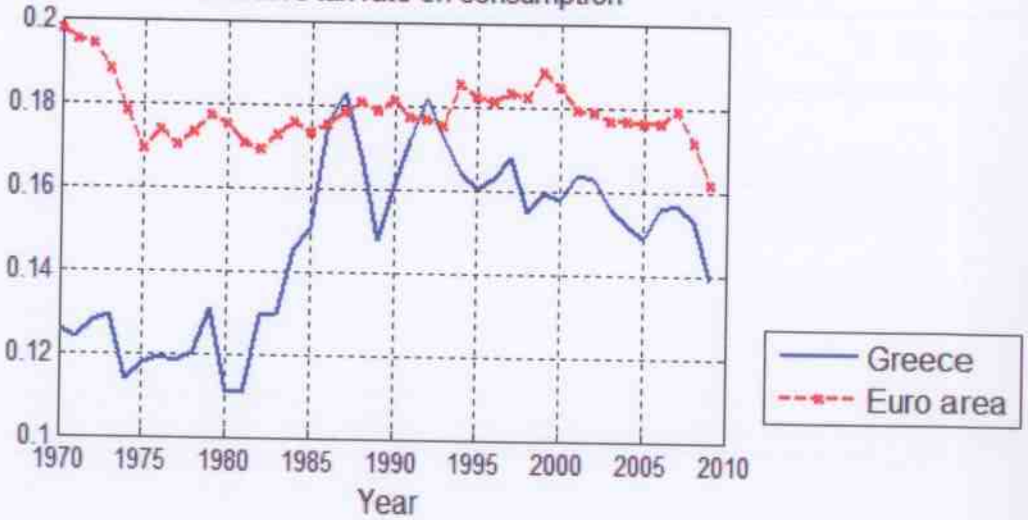


Tax revenues and effective tax rates

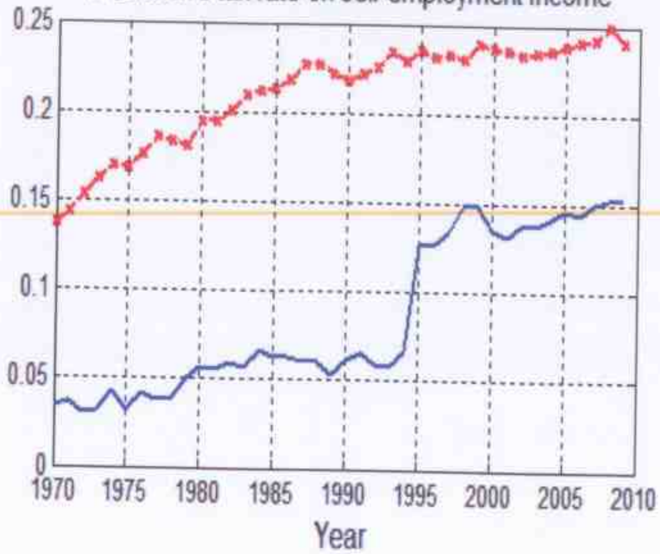
5. Effective tax rate on capital income



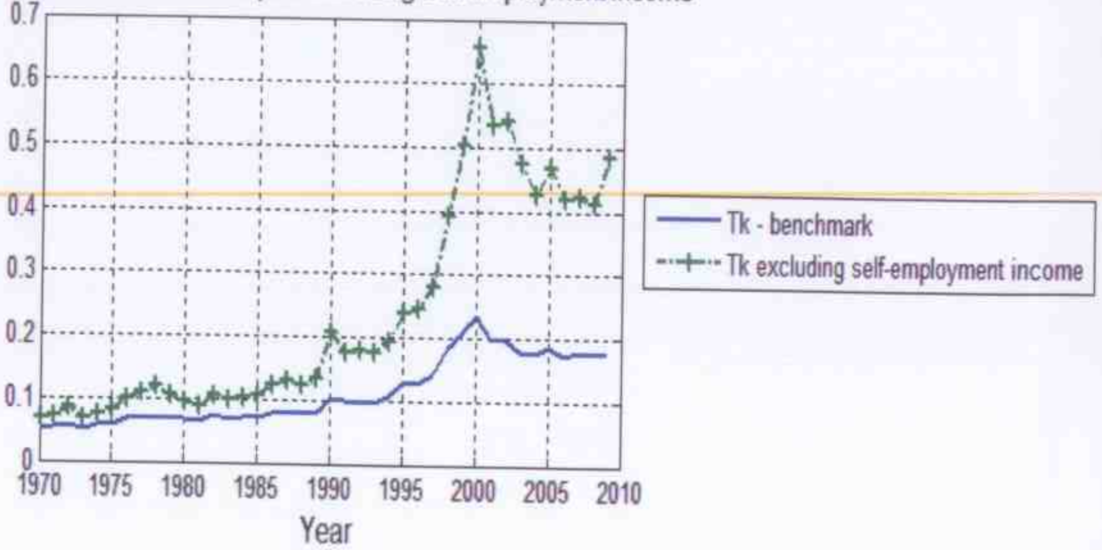
6. Effective tax rate on consumption



7. Effective tax rate on self-employment income



8. Effective tax rate on capital excluding self-employment income

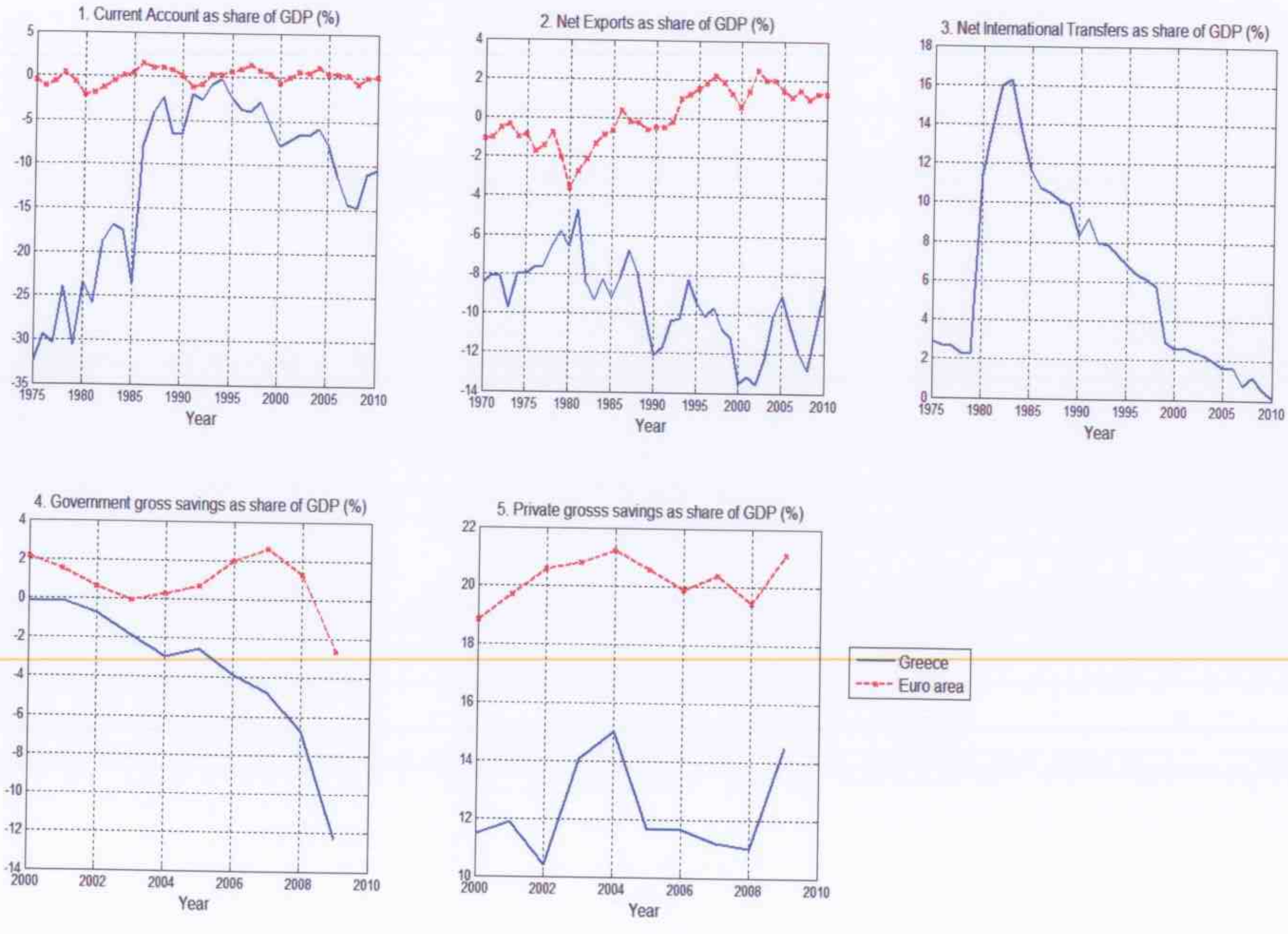


Taxation and revevues

- Direct revenues as a share of GDP and effective tax rates on all types of income are substantially below the Euro average.

- Lower effective tax rate in Greece reflects the well known tax evasion/compliance and tax collection problem. Whether the effective tax rates will rise or fall depends on the progressivity of the tax rate system and the idiosyncratic characteristics of the system.

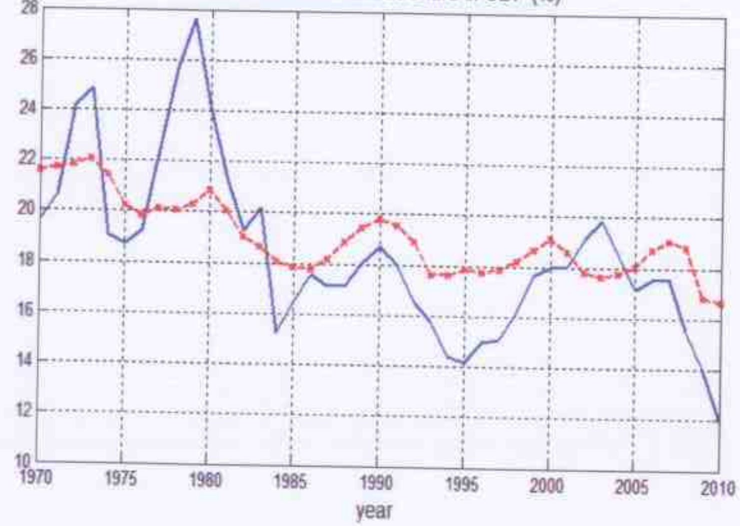
Key macroeconomic variables I



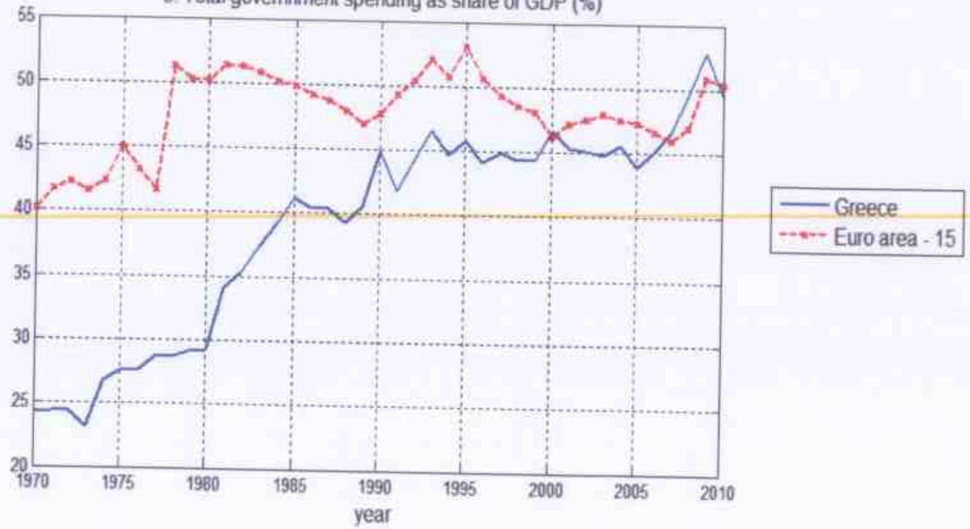
Key macroeconomic variables II

1. Private consumption as share of GDP (%)

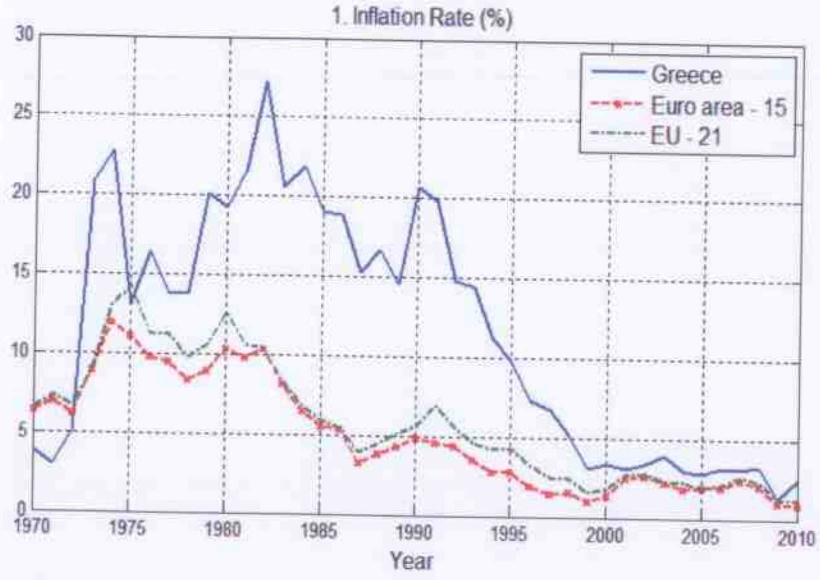
3. Private investment as share of GDP (%)

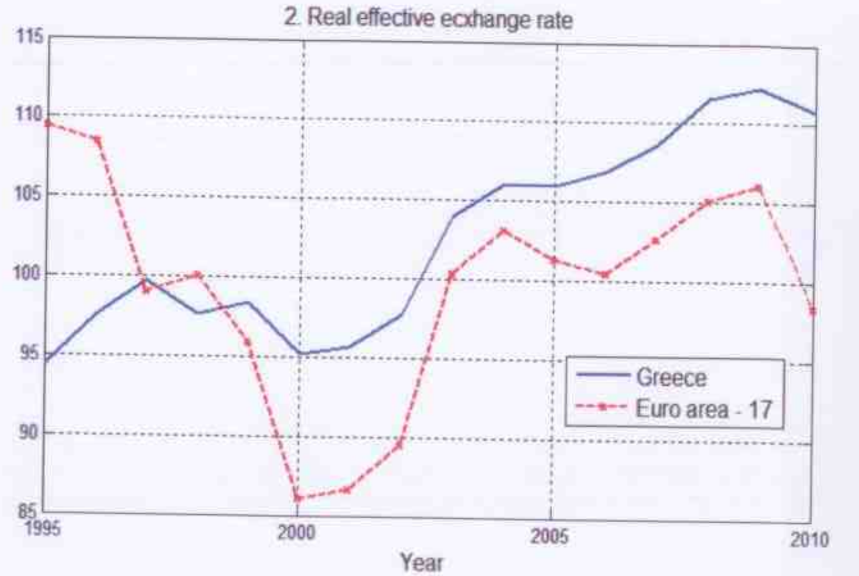


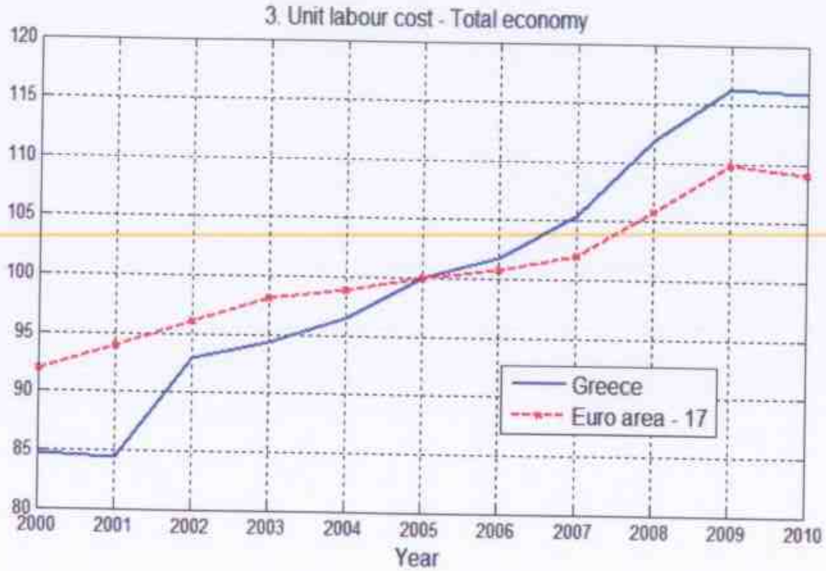
5. Total government spending as share of GDP (%)



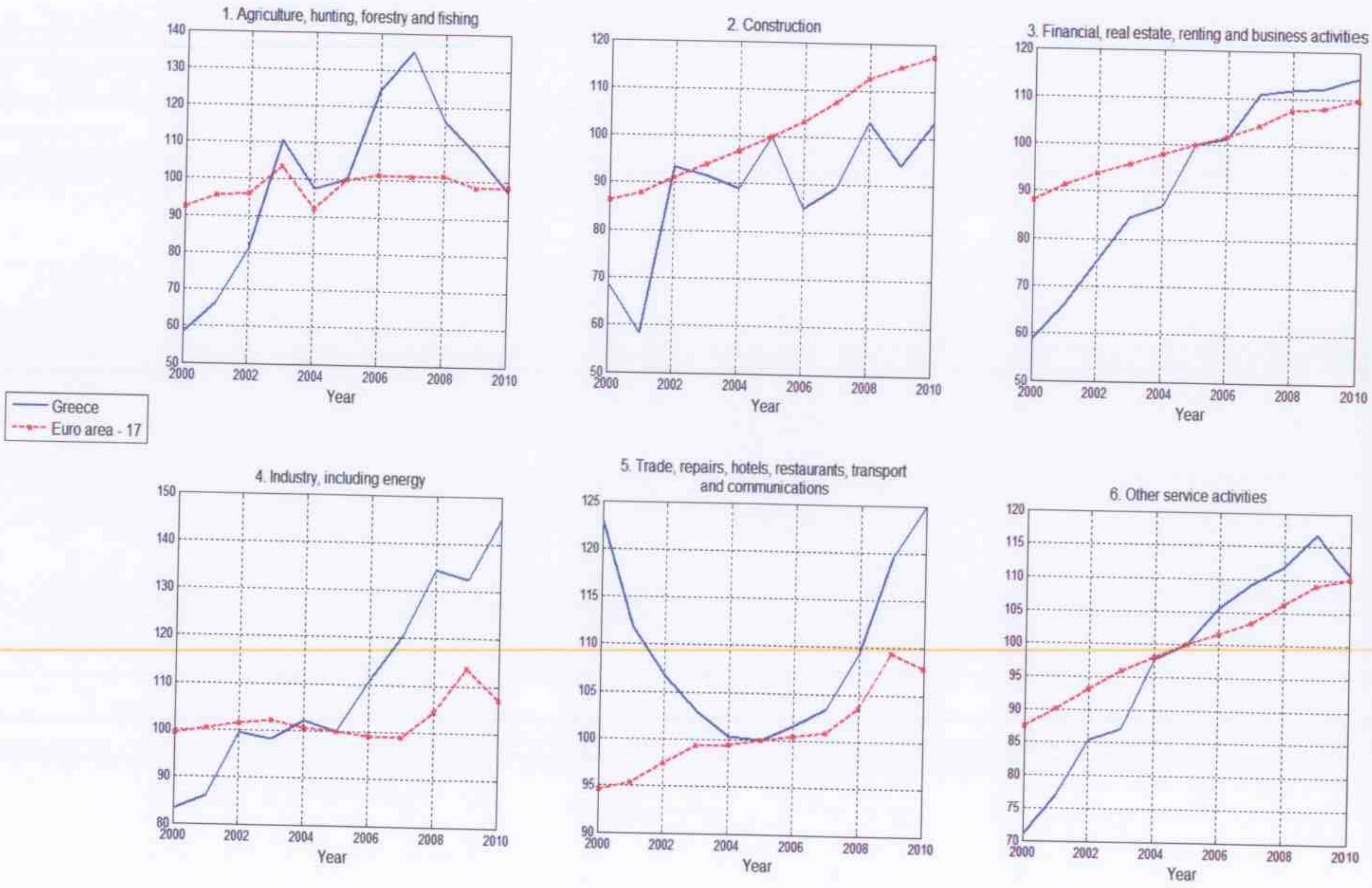
Inflation rates and real effective exchange rate







Unit labor costs in various sectors



Issues on Competitiveness and Productivity

- Inflation continue to be higher in Greece than in Euro area even after the entry in the EMU

- Real effective exchange rates increased faster in Greece than in Euro

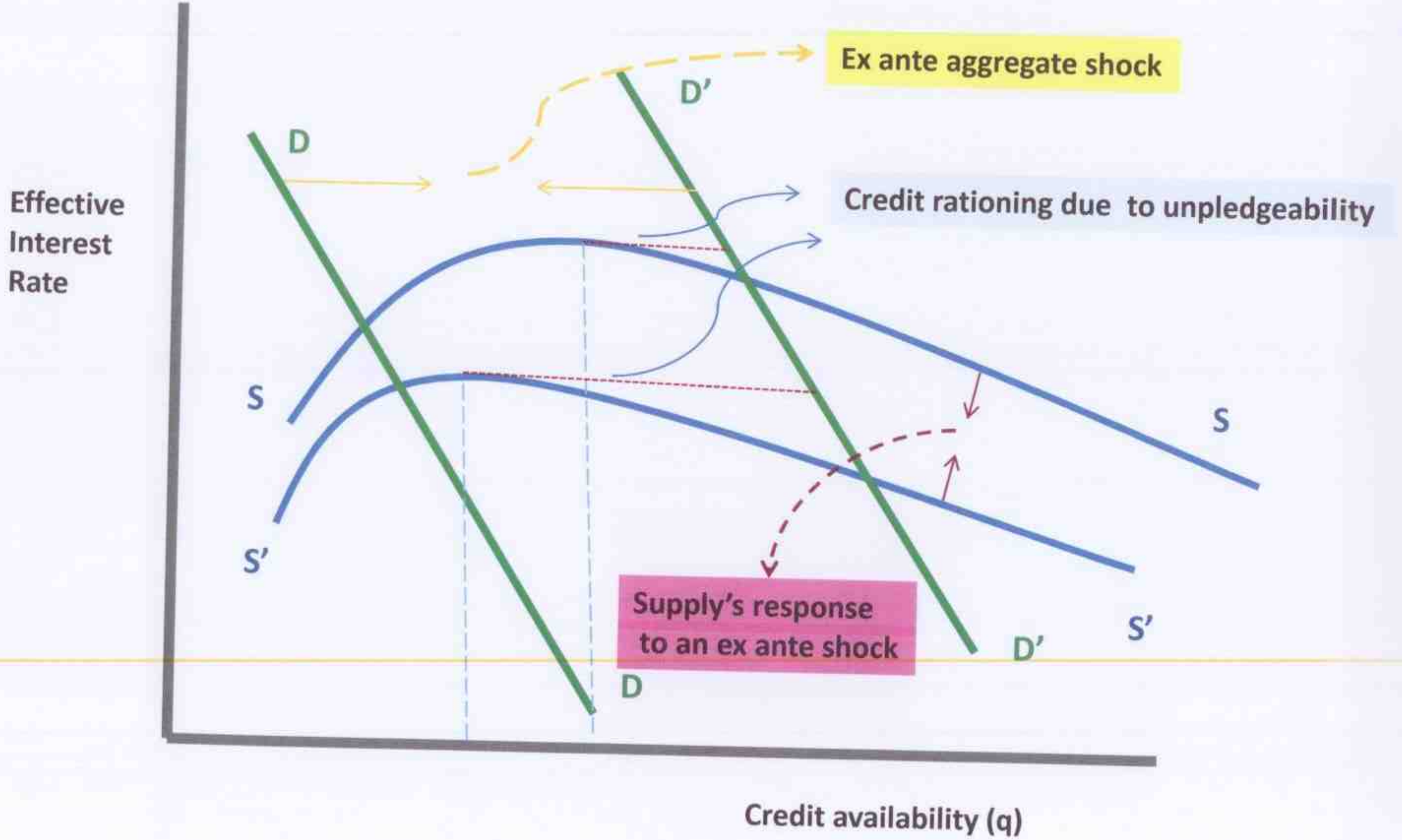
- Likewise unit labor cost primarily in state controlled and heavily unionized industries (energy, transportation, utilities) was higher in Greece. In regression the unit labor cost had a very strong negative effect on total factor productivity a major obstacle to current and future competitiveness

- To summarize the current conditions for the twin deficit problem, we should underline that a sharp run-up in public sector debt will likely prove one of the most enduring legacies of the 2007 -2010 financial crises in Greece. As it was expected from findings all across both advanced and emerging markets high debt/GDP ratio (+ 90%), it is associated with notable lower growth rates. Any attempt therefore to stimulate the economy with traditional methods (Keynesian type) is unrealistic. At those high levels debt intolerance push risk premia to rise sharply and credit rationing to restrict growth potential

Financial panics, cash-flow inefficiencies and adverse selection in markets of collateral

It is the purpose of this section to explain, how the twin deficit reality grouped with an illiquid environment puts Greece in an unlikely position. I feel confident to support the argument that Greece is a typical event of a standard mechanism of a balance sheet driven crisis – funding and margin spirals caused by and causing fire sale of assets, fight to quality and strategic hoarding of liquidity – all contributed to a large collapse on real activity. Politicians and authorities largely overlooked this systemic risk, or at least disregarded it.

Financial Panics, Cash Flow Inefficiencies and adverse selection in the Markets of Collateral



The economics of contagion: regulatory evasion

- A large literature describes how small shocks to one institution or to the economy may propagate in the financial system with cross exposure
- Very recently EU realized that the magnitude of a partial or global bailout for unregulated countries of the south is alarming. They were unregulated and at the same time could avail themselves of an access to a Eurozone safety net. They were allowed to borrow from other parties without being carefully monitored by the later. More importantly both markets and regulators have little information about the consequences of pulling the plug

The economics of contagion: the opacity of the system

- ➢ Ineffective monitoring
  - ✓ Cross borrowing and bilateral exposure
  - ✓ Decentralized information not held by a central bank or a Eurozone regulator
- ➢ Option: Multi-governement guarantees, or government bail-out
- ➢ A multipateral exposure should really be about saying

  ....I have an information that makes me trust you and so, I'm willing to accept the corresponding counterparty risk

Concluding Notes

- Liquidity mismatches and the overreliance on wholesale funding were at the core of failures and rescues in the recent crisis
- From the current crisis we realized that an important regulatory issue is whether one should append a liquidity measure to the solvency one.
- A realistic approach demands all sites to collaborate at the final stage in order to avoid cross country spillovers and financial contaminations.
- International bailouts as an issue *per se* in and for any financial system raise serious questions. But before we stand against them we should consider all the different objections raised in the past for various international regulatory and monitoring framework initiatives (starting from Basel I,II and ending to the most recent Frank –Dodd).Realistically up to now the world financial markets are still dominated by home-based regulations and we that we should live for much more.

Concluding Notes

- Dealing with problems of illiquidity and sovereign insolvency in order to capture a tractable insight we must use models with infinite horizons. Such models are not available by now. Therefore as an alternative, it's time to utilize cooperative understandings in order to safely navigate through shallow waters on short run.
- Finally we are still lacking behind a theory capable to provide a good understanding of all interconnections between corporate and public finance. Since now regulators and rating agencies focus on monitoring quantity of liquidity, ignoring to a large extent the qualitative aspect of it. But dealing with public insolvency is mostly qualitative and partially a quantitative issue. Corporate finance is not of great help to us. The bottom line is that monetary and fiscal bailouts are different in working. And effects towards a common objective of restoring the institutions' liquidity and solvency position and should conceived separately.