Hellenic Observatory panel debate

The Greek Fiscal Crisis and the Future of the Euro-Zone

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Thank you very much for inviting me here today. I'm flattered to be in such company. I only wish I could be more upbeat.

Can Greece correct its financial position and undertake the necessary reforms for future prosperity?

To make Greece's financial position sustainable will require an enormous adjustment – something like 10-12 percentage points of GDP in a couple of years or so.

And this without a devaluation, which would typically accompany a consolidation of this size in a country with a current account deficit as big as Greece's.

Investors believe the country can't pull this off. And their scepticism is understandable.

First, the starting point is very bad. Public debt is rising rapidly and from a very high level. The deficit is huge, the debt structure poor.

Second, and crucially, Greece's economic growth prospects are weak.

The country's financial position will not be sustainable against a backdrop of slump and probable deflation, however much the Greek authorities cut spending by.

But slump is where Greece looks to be heading. Its economy will probably contract by around 5% this year and prospects going forward look grim.

Greece needs a very big external stimulus to offset budget cuts and falls in real wages.

In short, exports need to grow much more rapidly than imports, for a lengthy period.

How likely is this? Not very. Import demand will be weak, of course, reflecting the collapse in domestic demand. But Greece also needs much stronger exports.

Unfortunately, exports account for just 20% of Greek GDP, so the percentage increase will need to be very big indeed.

In the absence of devaluation, Greece is dependent on a revival of demand elsewhere in the eurozone.

And the ability of Greek companies to become more price competitive and hence build their market share within the eurozone.

The best way of improving price competitiveness is through higher productivity. But that is a long term challenge. Greece does not have that kind of time.

The country has no choice but to try and cut costs relative to the rest of the eurozone. This is possible. Germany and the Netherlands have successfully pursued eye-watering wage restraint within the eurozone.

The problem of course is that it's impossible for every economy do this simultaneously.

It's one thing for a member-state to cut costs relative to the rest of the eurozone when most member-states' costs are rising pretty rapidly.

It's a whole different ball game to do so when costs elsewhere in the eurozone – especially Germany – are falling, reflecting further wage restraint.

A Greek debt restructuring looks unavoidable. Whatever finally come through from the EU/IMF will help a bit. But it is hard to see it being sufficient.

I think the question at this point is really about the degree of default.

What are the implications for the governance of the euro-zone and the future performance of the euro?

Greece is just the starkest example of the challenges facing member-states with very big current account deficits, weak public finances and poor economic growth prospects.

The failure to contain the Greek crisis means we are already seeing contagion to other member-states.

To believe that 'making an example' of Greece will force others to put their houses in order and secure the stability of the eurozone is simplistic.

It ignores that Greece's problems – and those of the other member-states - cannot be solved by them alone.

Indeed, the EU's strategy so far appears to have been tailor-made to provoke the kind of contagion everyone is so keen to avoid.

I think three things need to happen to ensure long-term stability.

1. The southern member-states of the eurozone <u>must</u> get serious about reform

Their elites have treated the euro as a shield

But membership is also a corset – it requires economies to have flexible markets for goods, services and labour.

Devaluation is not an option, so economies have to become more productive and flexible.

Unfortunately, the southern Europeans have shown little enthusiasm for reforming their highly regulated labour markets, or for increasing competition.

They have to honest about what they've signed up to.

2. The surplus member-states need to strengthen domestic demand

The German government is right to call for reform in Southern Europe. But weak domestic demand in Germany also threatens the sustainability of the eurozone.

If the eurozone economies with large external surpluses will not or cannot rebalance their economies, the struggling southern member-states will find it very difficult to extract themselves from this mess, almost irrespective of what they do.

Their fiscal positions, for example, will not improve if their economies contract faster than they can cut public spending. The result would be ongoing slump and fiscal crises.

Indeed, if Germany's economic model was exported to the rest of the eurozone, the result would be beggar-thy-neighbour wage cuts and slump.

3. There needs to be greater institutional integration.

The crisis has exposed the fallacy of believing that it's possible to have a bunch of largely sovereign countries sharing a currency.

There needs to far greater policy co-ordination and mutual oversight. In short, a move to economic government. Unfortunately, there is no agreement on what this would entail.

Eurozone finance ministers issued a statement in March saying that the unwinding of imbalances within the eurozone will require action by both deficit and surplus countries.

But various governments have made it abundantly clear that the only binding mechanism they will accept will be one to enforce budgetary discipline.

They will not sign up to any form of economic government that could require them to reduce their surpluses.

And there is certainly no chance of a move to any kind of fiscal union.

But unless the imbalances can be addressed, some kind of fiscal union would appear to a prerequisite for survival of the eurozone in its current form.