

LSE Hellenic Observatory
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COMMENTS ON:
“A FINANCIAL CRISIS MANUAL”,
T. THOMAKOS, P. MONOKROUSSOS,
& K. NIKOLOPOULOS

DIMITRI VAYANOS

LSE, CEPR & NBER

Book Summary

- Perspectives on EZ crisis and its manifestation in GR.
- Book has three main parts:
 - ▣ **Part 1:** Practitioners' perspectives on EZ-wide issues, incl. monetary policy, financial stability, fiscal policy.
 - ▣ **Part 2:** Perspectives on Greece, mainly on macroeconomics, fiscal policy, and debt management.
 - ▣ **Part 3:** Academics' perspectives on EZ-wide issues, mainly fiscal policy and long-run architecture.
- Valuable combination of academics' and practitioners' perspectives.

Discussion Plan

- Given time constraints, pick a subset of chapters.
- Chapters 6 and 7 on Greece.
 - ▣ Macroeconomics, fiscal policy, debt management.
- Chapters 2 and 14 on EZ.
 - ▣ New architecture, including fiscal policy.

Chapter 6: Build-up of External Debt

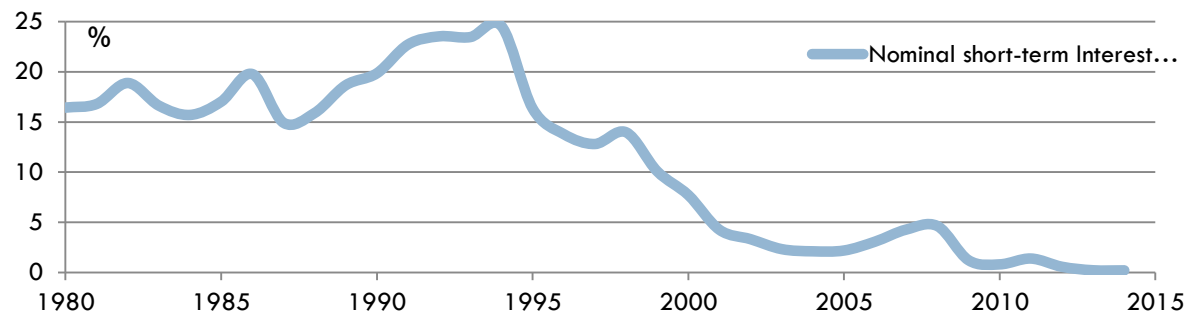
- Greece's current-account deficit regressed on a number of variables, including:
 - ▣ Real effective exchange rate (competitiveness).
 - ▣ Fiscal deficit.
 - ▣ Income gap with other EZ countries.
 - ▣ Financial liberalization.
 - ▣ GDP growth.
- These variables explain a significant part of the variation.
- BUT: Effects may not be causal.

Causality

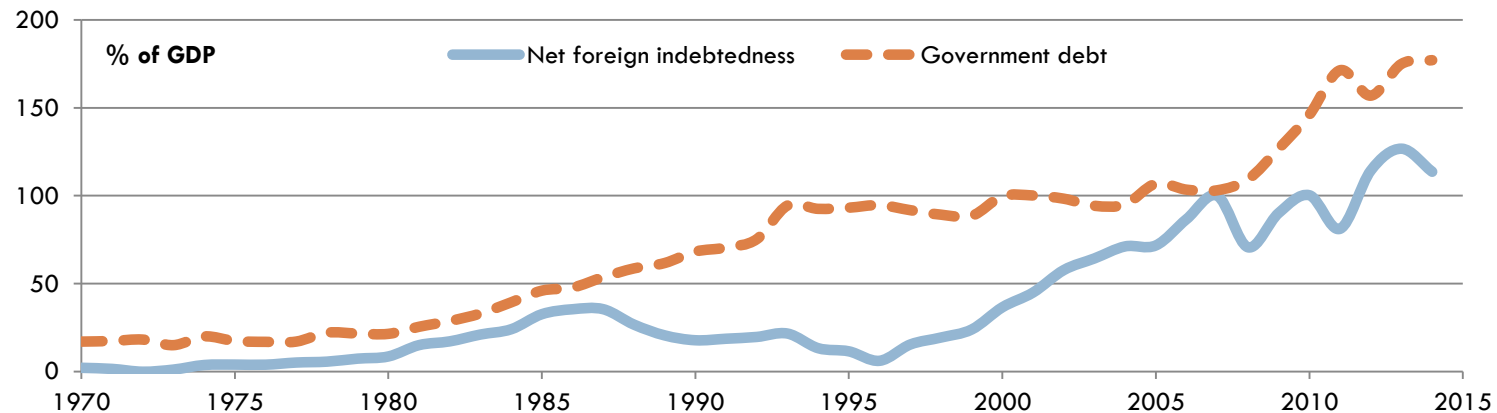
- Lower interest rates after EZ entry stimulated borrowing from abroad, and this led to fiscal deficits and loss of competitiveness.
- ▣ Wyplosz (2012) “EZ Crisis: It’s About Public Debts not Competitiveness.”

Interest Rates and Indebtedness

- Large drop in interest rates in run up to EZ entry.



- Small external debt in early 1990s despite large fiscal deficits in 1980s.

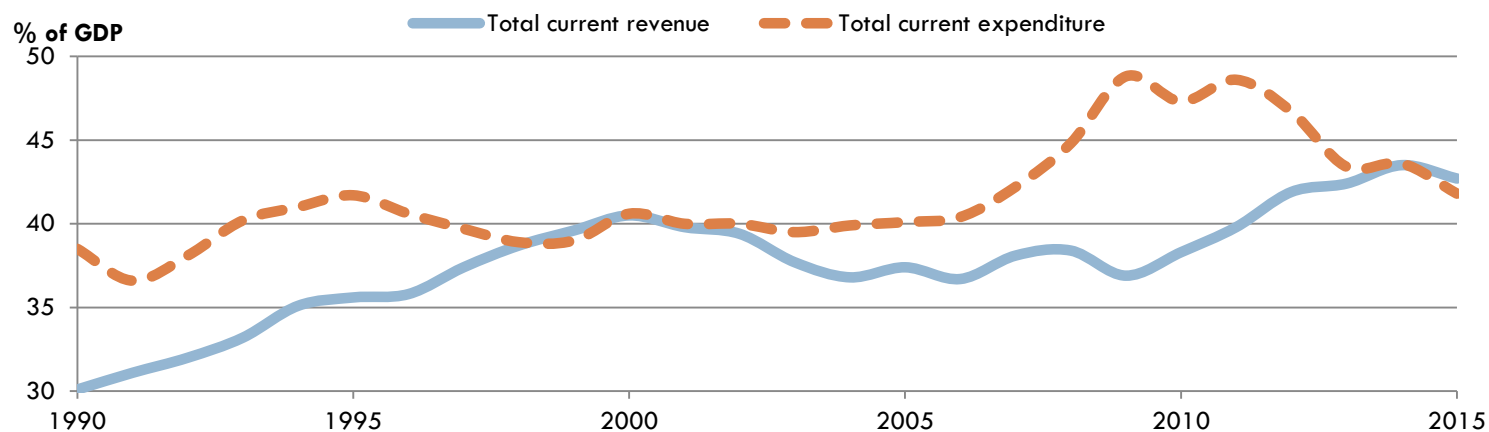


Chapter 7: Fiscal Multipliers

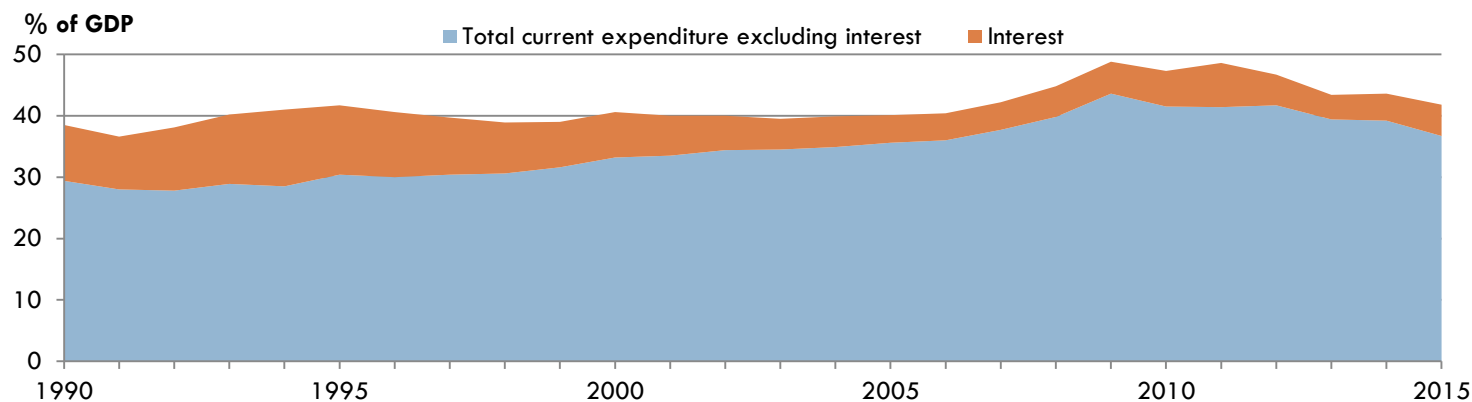
- Estimation of relationship between GDP growth, government revenue, and government spending.
- Fiscal multipliers (effects of changes in revenue or spending on GDP) are:
 - ▣ Larger for government spending than for government revenue.
 - ▣ Larger for spending on public investment than on primary items (e.g., wages and pensions).
- Implication: Better to raise taxes (or curb evasion) than to cut expenditure—especially on public investment.

Revenue and Spending in Greece

□ Current revenue and expenditure:



□ Interest costs vs. remainder of current expenditure:



Key Observations

- Boom after Euro entry:
 - ▣ Revenue declined by 2-3% of GDP relative to 2000.
 - ▣ Expenditure remained at its 2000 value until 2006, and then rose sharply, by 8% of GDP, until 2009.
- Crisis:
 - ▣ Revenue rose by 5% of GDP between 2009-2012.
 - ▣ Expenditure remained at its 2009 value until 2011, then declined.
 - Between 2009-2011, public investment (gross fixed capital formation) was cut by 1.4% of GDP.
 - ▣ Interest remained roughly constant as % of GDP.
 - ▣ Adjustment was driven primarily by tax rises and cuts in public investment, especially at early stages.

Tax Rises vs. Spending Cuts

- Adjustment should probably have relied:
 - ▣ Less on tax rises and cuts to public investment.
 - ▣ More on cuts to current expenditure.
- Alesina-Ardagna, (2010), “Large Changes in Fiscal Policy: Taxes versus Spending”.
 - ▣ Adjustment programs in which most of savings come from spending cuts yield smaller declines in GDP.
 - ▣ “2/3 spending cuts, 1/3 tax rises”.
 - ▣ In Greece tax rises accounted for about 60% of adjustment between 2009-2014.

Overtaxation

- Top rate for corporate income is 29%. EU average is 22.5%.
 - ▣ Bulgaria 10%, Croatia 20%, Cyprus 12.5%, Romania 16%.
- Top rate for personal income is 48%. EU average is 39.3%.
- Standard VAT rate is 23%. EU average is 21.6%.
- Implicit tax rate on labor (income taxes and pension contributions) is among the highest in the OECD for some worker categories.
 - ▣ Highest for married individuals with two children in a one earner family earning the average wage.
- Going forward, need:
 - ▣ Significant reduction in tax rates and pension contributions.
 - ▣ Stable tax environment for at least a decade.
 - ▣ Increase in public investment.

Back to Chapter 7

- Finding that public investment cuts are the most recessionary seems plausible.
- I am less convinced about finding that tax rises are less recessionary than spending cuts.
 - ▣ We should at least be cautious on policy implications (and authors do express caution).

Chapters 2 and 14

- Policies for a more stable EZ.
 - ▣ Fiscal coordination/monitoring.
 - ▣ Banking union. (Regulation, resolution, deposit insurance)
- Banking union is essential.
 - ▣ Some progress but more to be done.
 - ▣ Requires loss of sovereignty. (Less state control on banks)
- I am sceptical as to what can be achieved on fiscal front.
 - ▣ Better to strengthen market monitoring, with an clear and efficient regime for sovereign bankruptcy.