"The Greek Financial Crisis and a Developmental Path to Recovery: Lessons and Options"

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Abstract

The purpose of this paper is threefold: to contribute to the heated debate that takes place in Europe about how to deal with the Greek (as well as a similar) financial crisis; to describe the methods for addressing the problem and to examine possible scenarios for resolving the Greek crisis; and, finally, to propose feasible, realistic and effective developmental strategies for future economic growth in Greece.

Key Words: financial crisis, developmental policy, macroeconomic policy, Greece

1. Introduction: The Political Economy Context of Modern Greece

Since its inception in the early nineteenth century, the governance of the Modern Greek state has been dominated by rent seeking and corruption. The influence of the Orthodox Church on Greek nationalism and the patrimonial legacy of the Ottoman Empire have resulted in a rather weak civil society. Rather than wealth producing activities, the central organizing principles of the Greek society have been political patronage and rent seeking. The result has been a crony capitalist country with a disproportionately large state bureaucracy.

A few socio-political elements have changed overtime but the patronizing orientation of the Greek society remains intact. Since the 1930s, political parties have evolved from loose coteries of personalities heading extended patronage networks to centralized organizations. Their rhetoric legitimizing the redistribution of benefits has evolved too. Client groups receive benefits in the name of "social justice" or "national necessity" or "acquired rights." Political patronage has been disbursed through increases in public sector employment, regulations that limit competition, and the imposition of levies on transactions for the benefit of organized groups that are not part of the transaction. Providing a job in the civil service continued through the years to be one of the main instruments used by politicians to ensure voters' loyalty. Political parties in power continued to staff the civil service with their supporters, so the Greek bureaucracy grew enormously. Approximately two-thirds of the electorate lives partly or wholly on government handouts, which significantly affects the popular ideological narratives in the country.

The resulting governance system has encouraged corruption, discouraged wealth creation, and affected popular ideologies.[1] Social and political elites seek to capture resources for personal benefit. The view that the state is good and markets are bad is widespread, yet understandable in a rent-seeking society where all activities, including market transactions, are seen as wealth redistribution. The same perspective applies also to the activities of the Greek entrepreneurs, which are seen not as wealth creating but as a form of redistribution of existing wealth, leading to a pervasive wealth inequality (Pagoulatos, 2003; Agrawal, 2011).

The effects of "pork barrel politics" on the Greek society have been adverse in regards to the faring of the state economy, political affairs and civil rights. Pork barrel government action often vitiates prospects of foreign direct investment, drastically weakens the domestic market, and significantly restrains production and trade expansion. A favoritism-based political system can easily embezzle money from its citizens by misusing or misappropriating funds derived from tax payments. These funds could otherwise be spent on improving both the economic and social infrastructure of the nation. Furthermore, the popular narrative of "putting people above markets" has deepened clientelism and contributed to the current national crisis.[2]

The following sections present an overview of the Greek economic development and its impediments to growth (Section 2), examine the country's recent macroeconomic environment (Section 3), describe the methods for dealing with the financial crisis (Section 4), present possible scenarios for Greece (Section 5), and provide feasible development strategies for economic recovery (Section 6). Some final thoughts conclude the paper (Section 7).

2. Economic Development Overview and Impediments

The period from 1950 to 1973 was one of miraculous growth for the Greek economy. With both World War II and the Greek Civil War (between Nationalists and Communists) behind it, the Greek economy undertook a massive reconstruction effort. Similar to other European countries, the Marshall Plan was instrumental in the rebuilding of Greek cities and the construction of new infrastructure projects. There was an urban renewal that replaced the country's pleasant urban landscape of mostly low-rise buildings and homes with a monotony of characterless concrete blocks in most big towns and cities. The rapid growth of the economy was also facilitated by a drastic devaluation of the currency (drachma), an influx of foreign investment, the development of the chemical industry as well as the development of tourism and the service sector in general. Greek governments devoted themselves principally to expanding agricultural and industrial production, controlling prices and inflation, improving state finances, developing natural resources, and creating basic industries. During this period, the economy grew by an average of 7% per year, second in the world only to Japan. Industrial production also grew annually by 10% for several years, mostly in the 1960s (Maddison, 1995; OECD, 2010). Until 1973, Greece enjoyed high growth and low inflation, yet the growing economy initially widened the economic gap between rich and poor, and intensified political divisions.

The high growth period ended abruptly in 1974 with the collapse of the military junta (1967-1974), when the country recorded its worst annual contraction in GDP (about 5%) in its post-war history. In 1975, with democracy restored in Greece, the Karamanlis Conservative government undertook a series of austerity measures designed to redress the balance-of-payments deficit and curb inflation. Increased efforts at import substitution were undertaken in all sectors. A new energy program included plans for stepped-up exploitation of oil and lignite reserves, along with uranium exploration in northern Greece. Great emphasis was placed in the effort to admit Greece in the European Economic Community (the precursor of the European Union, EU), which was achieved by 1980.

The Papandreou Socialist government that took office in 1981 promised more equal distribution of income and wealth through "democratic planning", as well as measures to control inflation and increase productivity. It imposed controls on prices and credit, and began to restructure public corporations. The government was cautious however, in introducing what it called "social control of certain key sectors" of the economy, and commissioned studies for each sector. Its development policies emphasized balanced regional growth and technological modernization, especially in agriculture. The Papandreou government also introduced the "National Welfare State" for Greek citizens (especially the working classes and farmers) and "National Reconciliation" policies, which provided state pensions and benefits to repatriated Greeks, who had lived in exile since the end of the Greek Civil War in 1950. These new and unfunded state liabilities, without a significant arrest of tax evasion and black economy, contributed to the significant deterioration of the public finances, but were deemed necessary to bridge the schism between Nationalists/ Democrats and Communists that had divided the Greek people since the end of World War II.

The Mitsotakis Conservative government of the early 1990s adopted a two-year "Adjustment Program" that called for a reduction in the public sector deficit from 13% to 3% of GDP, the privatization of twenty eight state enterprises, and a reduction of price and wage increases. The Simitis Socialist government of the late 1990s was mainly focused on the policies necessary for Greece to gain admission to the European Monetary Union (EMU). As a consequence, his government instituted an austerity program aimed to tackle the chronically high inflation, and the bloated public sector. By 1998-99, these policies showed significant progress. Greece gained admission to the EMU in 2001, and adopted the euro as its new currency in 2002. Despite achieving such politico-economic successes like admittance to the European Union, adaptation of the Euro, and inclusion in the group of the thirty highly developed countries by the Organization for Economic Cooperation and Development (OECD), Greece shows pronounced signs of a transition country.

It has a high level of regulation leading to a significantly higher incidence of bribery, high taxes and fees on economic activities, and a large discretionary framework of regulations leading to a large shadow economy. Schneider (2000), and Schneider and Enste (2000) estimate the size of the Greek underground economy to be almost one third of the officially measured Gross National Product.[3] While high corruption levels can act as an incentive for underground activities, in general, it is when regulations are costly –in terms of money and time– that the "exit option" (i.e., the decision to go underground) becomes more attractive.[4] Three factors are considered particularly important for the size of the underground economy in a country: the tax and social security contribution burdens; the number of laws, regulations, license requirements, labor restrictions and trade barriers, which substantially increase costs in the official economy; and unsatisfactory public sector services. Katsios (2006) suggests that the bigger the shadow economy is, the lower the state revenues are, which in turn reduce the quantity and quality of publicly provided goods and services, reinforcing the motive to participate in the underground economy.

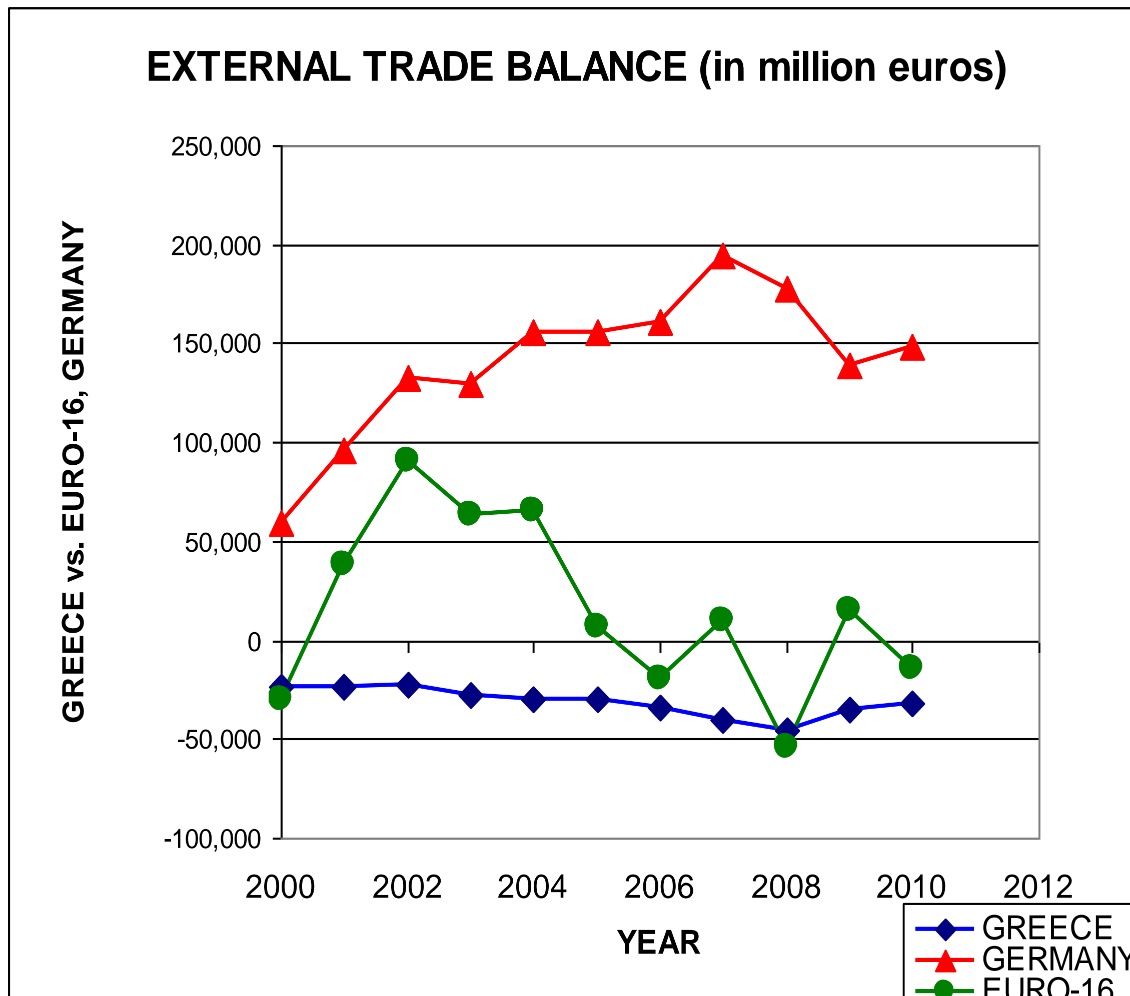
In addition to the large size of its underground economy, there are less developed and economically depressed regions in Greece, where the growth of resources, especially, capital equipment, machinery and new technology, has been slow. Various higher level activities have been seen to gravitate to Athens. Traditional policy making has neither been able to achieve substantial regional/local growth and industrial regeneration nor a significant improvement in competitiveness. Greek development policies do not seem to have addressed adequately and successfully problems like the short-term perspective in decision-making, the technical inefficiencies and failures to develop and promote new products and processes, and the lack of inter-business cooperation. There is a serious lack of research and development (R&D), innovation, on the job, and institutional training and retraining. Greek governments have tended to place little emphasis on government investments on the accelerators of industrial competency and competitiveness, while placing too much emphasis on financial incentives. And, as mentioned earlier, pork barrel intervention has had harmful effects on Greek economic policies (Karagiannis, 2002).

Bitzenis, Marangos et al. (2011) examine both the motives and the barriers for Foreign Direct Investment (FDI) affecting the level of competitiveness, entrepreneurship, and the business environment in the Greek economy. In terms of motives to enter the Greek market, and in the order of importance, the authors conclude that the prospects for market growth, political stability, economic stability, the size of Ggreek market, social stability, and the Olympic Games of 2004 were the most decisive factors for a preferable business environment that favoreds sound entrepreneurship and competitiveness. On the other hand, the primary barriers for FDIs in the Ggreek market and in the order of importance were bureaucracy, followed by the taxation system, corruption, corporate tax, the unfavorable labor market structure, and the unstable legal system. It appears that the banking -services sector is not affected by corruption, as the regu¬latory framework is mostly determined by the European Commission, the ECB, and the EMU. At the same time however, the European regulatory frameworkit creates inconsistencies with the Ggreek legal system, producing an unstable legal environment which affects banking (and other sectors) negatively.

3. Recent Macroeconomic Environment

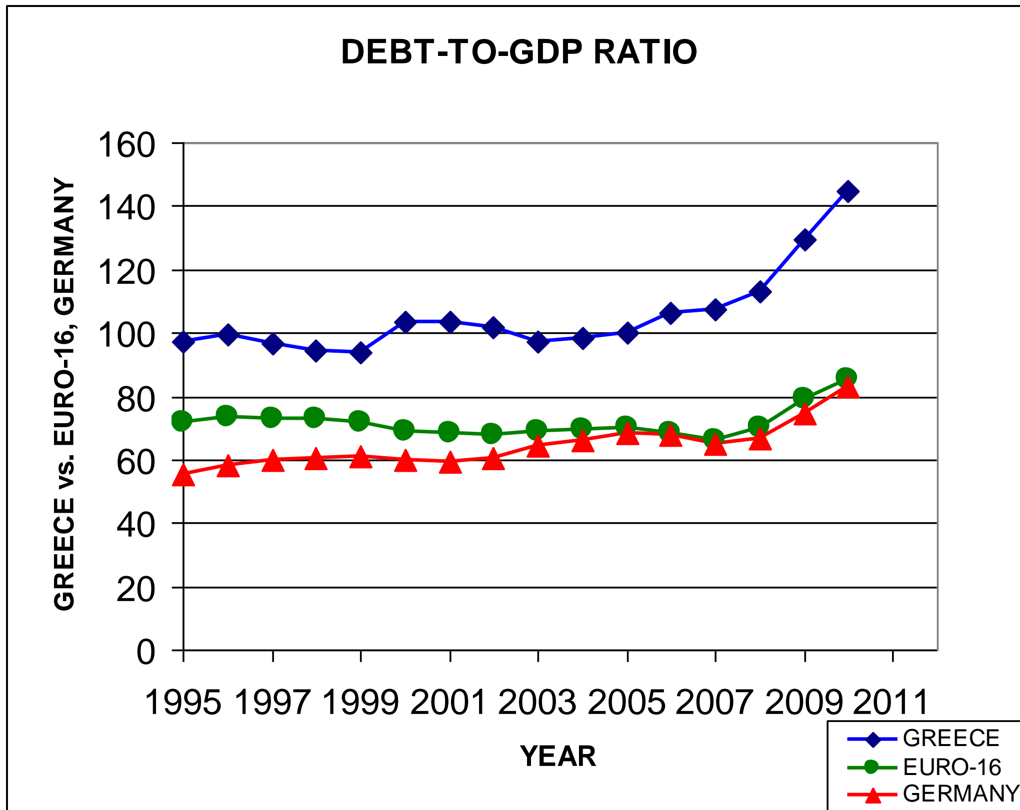
Greece is a predominately service economy. The service sector, including tourism, accounts for over 73% of GDP. Almost 9% of the world's merchant fleet is Greek-owned, making it the largest in the world. Other important sectors include food processing, tobacco, textiles, cement, glass, chemicals (including refineries), pharmaceuticals, telecommunication and transport equipment. Agricultural output has steadily decreased in importance over the last decades, accounting now for only about 5% of total GDP. More than half of all Greek two-way trade is with EU countries, making the EU Greece's major trading partner. Greece runs a perennial merchandise trade deficit and rising current account deficits (Graph-1). Tourism and shipping receipts together with EU transfers make up only for part of this deficit (Giannitsis, 2008; Alogoskoufis, 2009; Hellenic Statistical Authority, 2010).

Graph-1

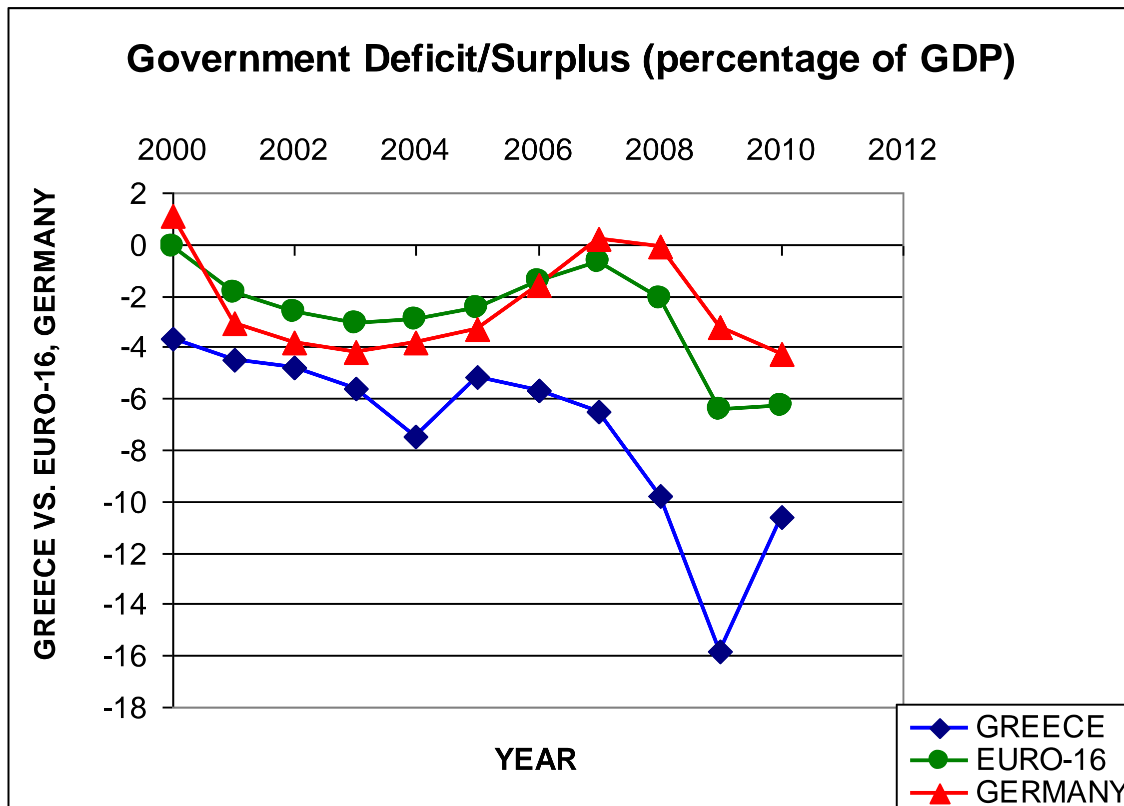


Greece adopted the Euro (€) as its currency in January 2002. The euphoria and optimism of a new era of economic growth and financial stability, from joining in a monetary union with a group of larger and more developed economies, overshadowed some lurking and persistent imbalances of the Greek economy. The Greek debt-to-GDP ratio was larger than that of other EU members (Graph-2). The budget deficit had only recently approached the euro zone Stability and Growth pact limit of 3 percent of GDP (Graph-3). The ever widening trade deficit was raising questions about the country's international competitiveness. Yet, in a triumph of politics over economics, Greece was deemed ready to compete with the much more developed northern European economies (Kondeas, 2011).

Graph-2



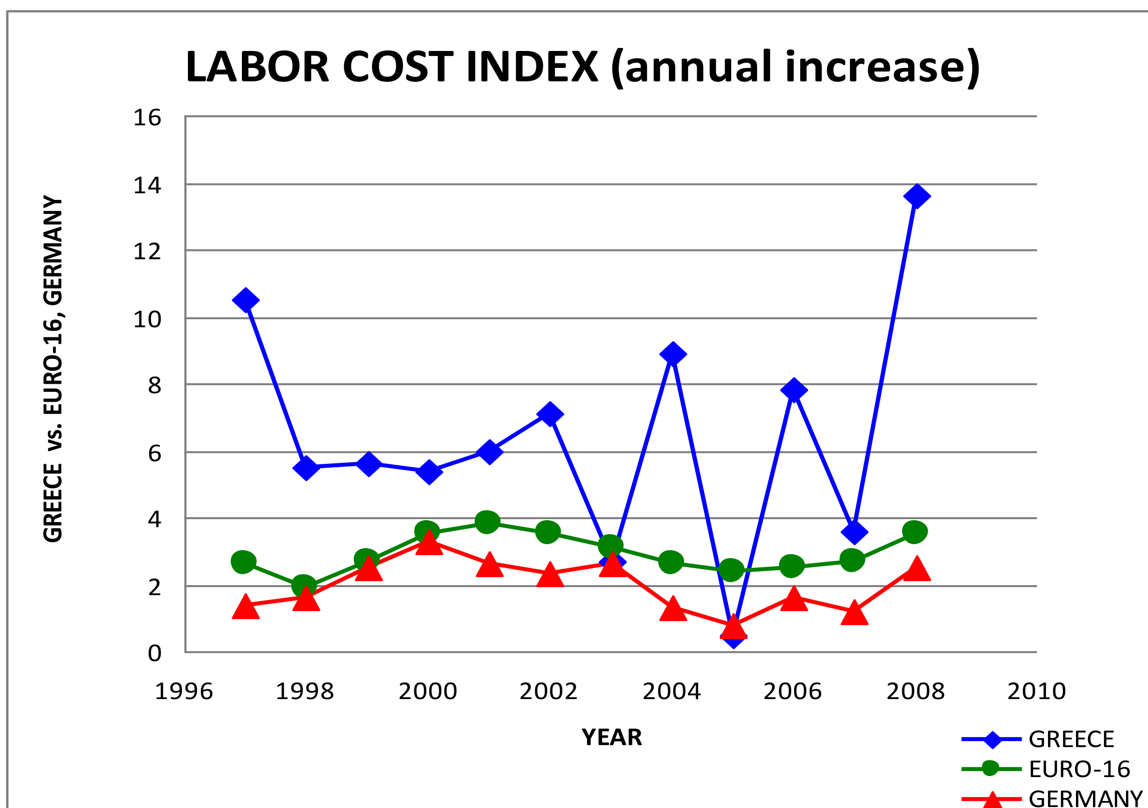
Graph-3



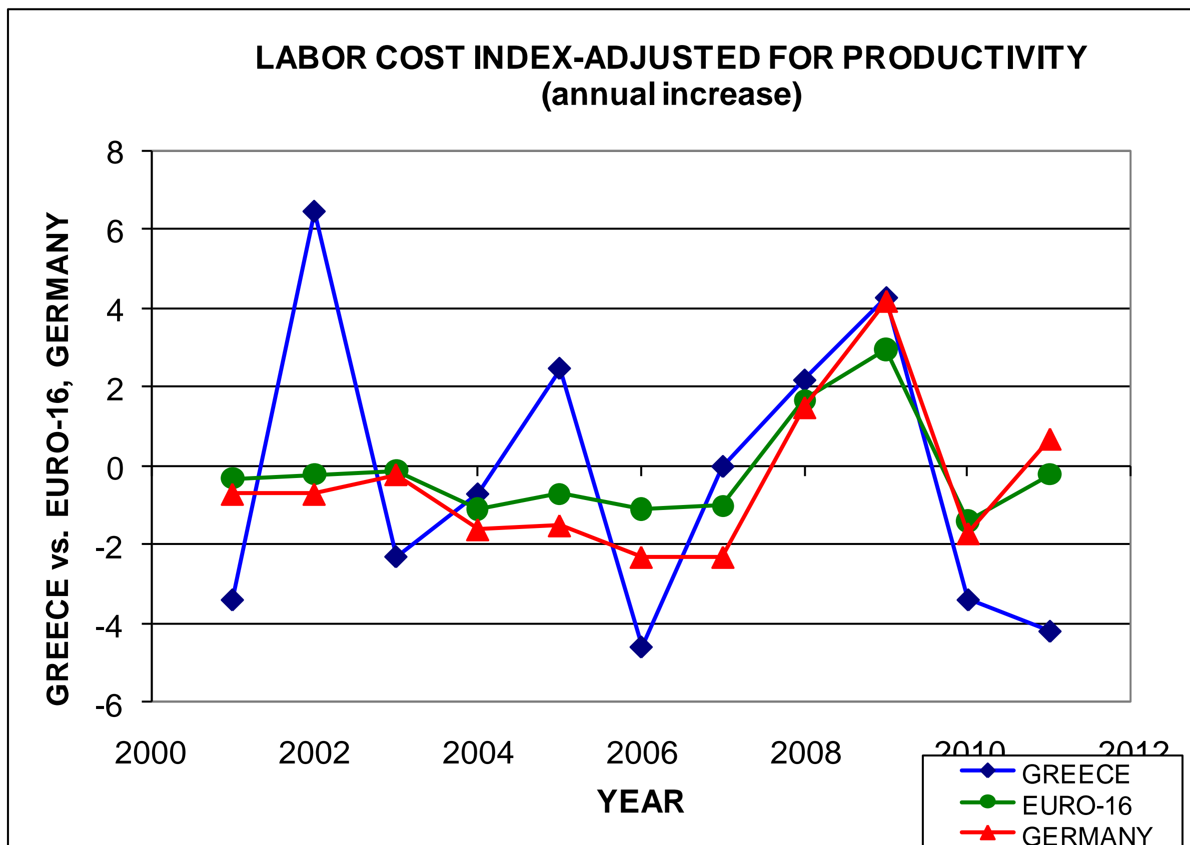
As it turned out, the monetary union was very successful in eliminating currency risk within the euro-zone, making the movement of capital between member countries free, fast, and safe. The ensuing euro zone-wide drop in interest rates, down to German interest rate levels, helped many of the member countries finance their growth and deficits. Greece however, did not take advantage of the access to cheap capital to build productive capacity and become internationally competitive. Whether there were unsuccessful efforts to build productive capacity, due to the lack of a developmental policy, or there was not enough productive capacity built to make the economy more competitive, is a matter of debate. The cheaper capital was used instead to fuel consumption spending, which nonetheless provided a significant boost to economic growth.

The new found economic growth was accompanied by an increase in wages and salaries, and Greek labor costs increased by 33% during the period 2001 to 2009. Meanwhile, during the same period, Germany adopted a very aggressive competitiveness strategy,[5] which led to an increase of German labor costs by only 6% during the same period (Graph-4). Even when the labor costs are adjusted for productivity gains (Graph-5), Greek competitiveness was eroded significantly during this period. As a result, Greece found itself priced out of international export markets (Kondeas, 2011).

Graph-4



Graph-5



Moreover, the conservative fiscal targets that were agreed upon with the Stability and Growth pact were soon forgotten. For most governments, the tax and spending decisions tend to serve primarily domestic politics as opposed to international considerations. The Greek governments not only granted the above mentioned wage increases through the Greek National Collective Labor Agreements, but also approved generous pension benefits at earlier ages than other countries. As the debt crisis was unfolding in 2009, the legal retirement age for all workers in Greece was 61 years, while the German retirement age stood at 67 years. Greek civil servants hired before 1992 could even retire earlier, at the age of 58 (as long as they have served for 35 years).

None of the above was a surprise to the European Union officials. The European Commission had placed Greece under its supervision between 2004 and 2006, as the Greek budget deficit had violated the Stability and Growth pact limit of 3% of GDP. Under the European Commission's scrutiny, the Greek government was able to reduce the budget deficit from 7.2% of GDP (2004) to 2.6% of GDP (2006). This improvement however proved to be illusionary and, when the Greek economic data were revised, the new figures revealed the budget deficit was reduced but not as much as originally thought (from 7.4% in 2004 to 5.7% in 2006). But by the end of 2009, the structural weaknesses of the Greek economy, aggravated by the global financial crisis, pushed the budget deficit to 15.8% of GDP, the government debt to 300 billion euro, the debt-to-GDP ratio to 129.3%, and both Standard & Poor and Fitch credit rating agencies downgraded the country's credit worthiness.

In April 2010, Greece requested the support of the EU in securing credit at "reasonable" interest rates. Since no such scenario had been anticipated at the onset of the monetary union, there was no framework for handling such a "bailout" request from a member country. With some deliberations, the European Financial Stability Facility (EFSF) was established, and the EU in coordination with the International Monetary Fund (IMF) agreed to extend a credit line to Greece to keep servicing its debts. Specifically, the Greek parliament, Euro-area leaders, and the IMF Executive Board approved a 3-year €110 billion (about $145 billion) adjustment program to be monitored jointly by the European Commission, the European Central Bank, and the IMF.

In exchange for the credit line, the Greek government agreed to implement painful fiscal austerity policies mandated by both the EU and the IMF. Under the program, Greece has promised to undertake major fiscal consolidation and to implement substantial structural reforms in order to place its debt on a more sustainable path and improve its competitiveness so that the economy can re-enter a positive growth trajectory. The 3-year reform program includes measures to cut government spending, reduce the size of the public sector, tackle tax evasion, reform the health care and pension systems, and liberalize the labor and product markets. Greece has committed to reduce its deficit to less than 3 percent of GDP (the ceiling under the EU's Maastricht Treaty) by 2014. The ability of the Greek government to keep drawing quarterly installments from the established credit line will depend on both EU and IMF approving the progress of the implementation of the austerity policies as well as the implementation of any other structural changes these international facilitators may deem necessary for the Greek economy.

4. Methods for Dealing with the Crisis

Despite the efforts to address the Greek financial crisis, Greece entered 2012 with an estimated GDP of €217 billion and government debt of €360 billion. These figures point to a remarkable debt-to-GDP ratio of about 166. This means that even with the EU/IMF loans, which carry 4.5% to 5.5% interest rates, and assuming no more declines in GDP, Greece will need to be spending 8.3% of its GDP (€360 bn x 5% = €18 bn) and 28.5% of the government revenues (€18 bn/€63 bn) each year just for coupon payments. Clearly such a debt level is unmanageable, and it will have to be addressed sooner rather than later. Typically, there are four methods dealing with excessive debt levels. In order of political desirability, these methods are: growing the economy out of debt, monetizing the debt, saving and paying down the debt, and defaulting or restructuring the debt.

A. By far the most preferable method will be to grow the GDP much faster than the debt, so the Debt-to-GDP ratio would shrink over time, seemingly without much pain for the country. Historically this was achieved by the US after WWII, UK after the Napoleonic wars, and more recently Indonesia after the 1997 Asian financial crisis. The problem with this method however, is to correctly identify and pursue the source(s) of economic growth. It would be really helpful if Greece could export its way out of the five year long recession that started in 2008 (-0.2%, -3.3%, -3.5%, -5.5%, -2.8% drop in GDP expected for 2012) and return to a vigorous pace of economic growth. Unfortunately, due the lack of competitiveness described in the previous section, Greece has a persistent current account deficit ranging from 10% to 15% of GDP. Without its own currency to devalue to gain some artificial competitive edge for its exports, Greece can only count on an internal devaluation or a miraculous reversal of trade flows within the EU to grow its exports. Both ways however require time in order to be materialized. The internal devaluation implies lower labor costs in the form of lower wages, lower pensions, and/or longer work hours per week for Greek workers. It also implies the relaxation of job security laws and the opening of "closed" professions (attorneys, engineers, pharmacists, etc.) to bring more competition and lower costs in all these economic activities. All these measures are currently pursued by the Greek government, and despite fierce resistance by labor unions and professional organizations, there is actual progress in this front. Greek labor costs declined 3.4% in 2010 and another 4.2% in 2011. Still, according to Eurostat, Greece is looking at another double digit current account deficit and another economic contraction this year.

Another problem with the growing out of debt method is that once the government Debt-to-GDP ratio becomes excessive, this method becomes less effective. For instance, if the fiscal debt was equal to the GDP (100% Debt-to-GDP ratio), then the GDP would need to grow annually by the average coupon rate of the debt (assume 5% the current average of the EU/IMF loans) to generate the coupon payments, without imposing any pain to the private sector in the form of higher taxes, or needing to generate current account surpluses. But now that the Greek Debt-to-GDP ratio is 166%, the GDP would have to grow by 8.3% (5% x 1.66) annually to generate the coupon payments to service the public debt. This is a very high growth rate, realized only by a handful of developing nations around the world. So, unless the Greek private sector suddenly improves its productivity remarkably, or the double digit current account deficit suddenly turns out to be a sustainable surplus, Greece will not only grow itself out of debt but will not be able to even stabilize the Debt-to-GDP ratio at the current level; not from this size debt, and not with any reasonably attainable economic growth rate.

B. Creating inflation reduces the real value of debt and makes it easier for debtors to pay back their debts, all at the cost of domestic consumers who suffer a loss of purchasing power and declining living standards.

Japan with a Debt-to-GDP ratio of more than 200%, and both the US and UK with Debt-to-GDP ratios of more than 100%, all manage to finance their debts with the assistance of their Central Banks, who effectively monetize the government debt with Quantitative Easing (QE) schemes. Unfortunately, Greece does not have this option available for dealing with its debt, as it does not have its own currency anymore. Monetizing EU government bonds is in the purview of the European Central Bank (ECB), which under the pressure of some EU members (mainly Germany and Austria) had resisted taking any such actions until right before the December 2011 EU summit.

A policy of monetizing EU government debts would certainly ease the burden of debtor nations like Greece, Italy, Spain, Portugal, Ireland, and maybe even Belgium and France, but it runs against a deep philosophical divide with fierce proponents on either side of the argument. The issue here is none other than the nature of money itself. The debtor nations, either because of belief or circumstance, view money as tool which could and should be manipulated to meet economic or political goals like fighting unemployment, creating economic growth, etc. This end-justifies-the-means approach in effect suggests that destroying (some of) the value of the euro, by monetizing government debts, is justified in order to save the union and the euro itself.

On the other hand, the surplus nations view money as a common good, which does not belong to governments to use as they wish with it. Instead it belongs to people, who use it to store their wealth. It is precisely for this reason that debt monetization is explicitly prohibited by the EU treaties or the ECB by-laws. Any such debt monetization would violate EU laws, and destroying the law would be more dangerous than destroying the union or the euro. No one would want to be part of a union, whose members don't follow the union rules. No law should be broken to salvage a currency which does not seem to work for many of the union members. Surplus nations simply argue the solution is not to destroy the money but to adhere to the fiscal discipline treaties that the member states have signed.

While the debate will probably continue for as long there is money in some form or another, and while the ECB official rhetoric is that it does not plan to engage itself in broad scale programs to buy up government debts, the ECB, under pressure to provide support for European banks it introduced a three-year Long Term Refinancing Operation (LTRO) three days before the December 2011 EU summit. Under this LTRO, the ECB in effect introduced a form of a carry trade for European banks, which can borrow from the ECB at the core rate of 1% for a three-year period, and use the funds to purchase government bonds yielding upwards of 5%. While 523 EU banks used the LTRO during the first two weeks of the program to borrow €490 billion, by the first week of January 2012 €458 billion had been re-deposited back to the ECB to earn a 0.25% annual return. Apparently EU banks seem to have no desire to load up on EU periphery government debt, particularly after spending two years and two stress tests getting rid of such debt, which according to Basel III does not count anymore as zero-risk-weighted assets. It seems therefore unlikely that Greece will be benefiting significantly from any indirect ECB attempts at debt monetization.

C. Saving and paying down the debt is always a painful option for an indebted state. The EU/IMF assistance loans however, are dependent on the implementation of some severe austerity measures by the Greek government. The budget deficit (15.8% in 2009) will have to be eliminated, more than 150,000 civil servants will have to lose their jobs, and the remaining ones will have to accept severe (20%-40%) salary cuts. All state pension benefits will have to be permanently reduced, and the welfare state will have to be curtailed. State enterprises will have to be privatized, which will probably require first to downsize their labor force to make them lean and attractive to private investors. But in a three-sector economic model, comprised by the private (households and businesses), public (government), and foreign sectors, the deleveraging of the public sector can only come at the expense of the other two sectors (Parenteau, 2010). Since Greece has a double digit current account deficit, the whole burden of the government budget cuts will have to fall squarely on the shoulders of the Greek private sector. Higher unemployment and lower incomes tend to yield lower tax revenues and ascending Debt-to-GDP ratios. Indeed, the Greek economy has been shrinking (-3.5% in 2010, -5.5% in 2011) since the implementation of the EU/IMF austerity plan. The current unemployment rate, 19.2%, has more than doubled between 2009 and 2011, while youth unemployment escalated to 47%. At the same time, the Debt-to-GDP ratio has climbed from 126.8% before the plan, to 166% at the end of 2011, and the IMF is expecting it to reach 187% in 2013. Continuing the austerity plan will cause a further deterioration of the economy with severe and prolonged income losses, which will increase loan defaults and bank losses, causing bank failures.

To prevent any further credit contraction, and to preserve a functioning banking system, the Greek government will be forced to bail out and recapitalize domestic banks. That will require even more government debt issuance, which will make the value of the government bonds slide closer to the abyss. That will also cause the erosion of the asset value of the Greek banks, which are heavily invested in government bonds (€50 billion) and will require higher recapitalization, therefore more government debt. Clearly, austerity alone pushes the Debt-to-GDP ratio to the wrong direction.

D. Defaulting or restructuring the debt for either the private or the public sector is merely a financial tool, and a necessary one for heavily indebted parties. Despite of being portrayed by financial media as catastrophes, history is full of examples of sovereign debt restructurings and defaults. Reinheart and Rogoff (2008) report 238 such incidents since 1800. Spain alone has done so 13 times during this time period. More recently, Russia defaulted on its foreign debt in 1998, and Argentina followed suit in 2001. It was not the best of times, but certainly it was not the end of the world for these countries.

The original 2010 EU/IMF assistance plan for Greece had no provisions for any debt restructuring. EU leaders considered any debt relief as posing a great moral hazard problem for all debtor EU members, who could violate the fiscal discipline treaties they have signed knowing their debts could be erased too. Austerity alone was deemed sufficient to put the Greek public finances in order. The deterioration of the Greek economy that ensued during the following twelve months forced the July 21, 2011 EU Summit, to contemplate a 21% Greek debt restructuring. It involved no reduction in the face value of debt, just delay of debt repayment. Soon after the Summit, the IMF voiced its concerns about the effectiveness of such a minimal restructuring in dealing with the Greek problem and called for further measures to be negotiated. The October 26, 2011 EU Summit resulted in the Brussels Agreement, which was centered on a voluntary 50% reduction of the face value of the Greek debt issued before May 2010, and held by private investors (Private Sector Involvement – PSI). The loss apparently had to be "voluntary" to avoid the activation of Credit Default Swaps (CDSs), which could destabilize the issuers of these contracts and spread the financial losses to counterparties around the world. Furthermore, to protect the EU and the IMF from losses on their assistance loans to Greece since May 2010, the agreement excluded these Institutions' funds extended to the country.

The much heralded Brussels Agreement left many critical details unresolved. For instance, there was no obvious reason to expect private investors will "voluntarily" accept a 50% loss on the face value of their Greek bond holdings, at least not from those holding CDSs which would be made whole if the CDSs were triggered. Another issue with the Agreement was that the ECB was placed over and above other private or public bondholders of Greek debt, since it was excluded from the 50% restructuring of its €55 billion Greek debt holdings. Finally, and perhaps more important, even if the agreement was fully implemented, it would only provide an insignificant relief for Greece. The Agreement officially would shave off around €100 billion of the Greek debt. But to entice private bondholders[6] to accept the "voluntary 50% PSI, the Agreement offered them a €30 billion collateral payment in case Greece failed to repay the remaining 50% of the bonds' value. The €30 billion would have to be borrowed by the Greek government, unless the privatizations of Greek state enterprises were finally to materialize and yield this amount. Therefore, the PSI would reduce the Greek public debt at most by €70 billion. Given the October 2011 face value of the debt (€360 billion), the PSI would effectively reduce the Greek debt by 19.44% (€70 bn/€360 bn) leading to a 134% Debt-to-GDP ratio (€360 bn-€70 bn/€217 bn). Obviously, any further deterioration of the Greek GDP would easily send the Debt-to-GDP ratio above 150% once again.

The omissions and vagueness of the Brussels Agreement necessitated the December 11, 2011 EU Summit to kick start a new round of negotiations for the solution of the Greek problem. Several proposals dealing with the shortcomings of the Brussels Agreement were considered. First, Greece was to retroactively introduce a Collective Agreement Clause (CAC) to its bonds to force minority investor holdouts to accept the "voluntary" PSI the majority of investors will accept. Second, the ECB could sell its €55 billion of Greek bonds to the EFSF, or back to the Greek government which would receive EFSF financing. This would prevent the ECB from realizing any losses it could ill-afford, in case it became legally obligated to participate in the PSI. At the end of 2011, the ECB had €6.36 billion paid-in-capital against €2,733 billion assets. This yields a 430-to-1 leverage ratio (assets/capital), or alternatively a 0.23% capital ratio. Simply put, the ECB was not (and still is not) sufficiently capitalized to handle any losses in its asset portfolio. Third, the proposed "voluntary" haircut had reached a magnitude of 70%-90% (PSI+).

Moreover, it seems that EU leaders were now the ones pushing the private bondholders to accept larger losses in order to make the Greek debt viable, so their governments would not be on the hook again for more assistance in the future. The EU leaders seemed to have come to the realization that it would be preferable to eliminate the systemic risk and unpredictable losses from a panic caused by a possible Greek default, even if the EU governments had to bear the cost of recapitalizing some of their banks subjected to the PSI+ and suffering some very predictable losses. As a result of this pressure on the banking sector by the EU leadership, the final participation rate in the PSI bond exchange program reached 96.9% by April 2012, according to the Greek Debt Management Office. However, even with the PSI bond exchange the Greek government debt remains at €266 billion, resulting in a 122.58% Debt-to-GDP ratio, which is still high and risky for the country's economic stability (Greek Secretariat General of Information, 2012).

It is perhaps ironic that within the two years since Greece asked for the assistance of the EU and the IMF, the EU leaders have shifted their position from the moral posturing of no-debt-relief to the arm-twisting of their banks to accept 70%-90% losses on their Greek bonds, in the hopes of ring-fencing the systemic risk of future defaults. This is however what happens when politics hit the wall of economic reality, and it is a step in the right direction for solving the Greek problem. It is a formal recognition that austerity alone cannot address the problem sufficiently. While the EU leaders wasted two years relying on only one of the methods of dealing with debt, the Greek financial situation has deteriorated. It is finally time to employ all methods available to find a viable solution to the Greek financial crisis. The future of Greece and perhaps the future of the European Monetary Union depend on the policy steps or missteps the EU leaders will take attempting to stabilize the Greek economy.

5. Possible Scenarios for Greece

Realistically, there are only two main scenarios possible for Greece:

A. Under the first scenario, the EU leaders, having learned from the policy mistakes of 2010-2011, will deploy all four methods described in the previous section to bring stability and growth back to the Greek economy. The Greek economy will be revived, the monetary union will be saved, and the dream of a political union will remain intact. The following policy proposals can provide evidence that the EU is committed towards this outcome: the Greek government debt, after all negotiation iterations, will be restructured to a size that will bring the Debt-to GDP ratio to a more manageable level of no more than 100% of GDP. The ECB will monetize part of the Greek debt by acting as a lender of last resort to Greek banks, which will continue borrowing from the ECB placing government bonds as collateral.

Furthermore, to increase liquidity and maintain a functioning banking system, the EU leaders will create (sooner rather than later) a European Deposit Insurance Corporation (EDIC) to guarantee EU bank deposits and prevent bank runs. Currently, there are only national deposit insurance schemes, which have no credibility with depositors in countries in financial distress. Greek banks have lost more than 26% of their deposits in two years (from €238.5 billion at the end of 2009 down to an estimated €175 billion at the end of 2011). Depositors have come to realize that a government unable to borrow to pay its bills will certainly be unable to guarantee depositors' funds. Once deposits in Greek banks are deemed safe again, the Greek banks will regain the necessary liquidity to lend and jumpstart the economy.

The structural changes in the Greek economy will certainly be continued, but the austerity program will slow down to avoid suffocating economic activity and shrinking the GDP. For instance, balancing the government budget will have to be probably postponed until 2015, instead of 2012, which was originally demanded by the EU/IMF plan. Policy emphasis would be placed towards growing the economy again. This preferred method for getting out of debt has been completely ignored this far. However, with the Greek public and private sectors starved for investment funds, this task will have to fall on the shoulders of the EU. In coordination perhaps with the World Bank, the EU will create and oversee an investment fund for the "reconstruction" of the Greek economy. The fund will target areas of the economy that will increase the country's international competitiveness. Such strategies are presented in Section 6.

For policies like the ones listed above to take place and this scenario of European unity to prevail, EU leaders will have to come to realize and accept that all EU members will never be equally competitive. Therefore, some members will always be richer and some will always be poorer.

But to the extend that the participation of the less competitive members in the Union provides benefits to the more competitive ones, the latter should be willing to transfer some of these benefits to the less competitive members to keep them in the Union. This is not unlike the wealthier US states subsidizing the poorer states through their federal taxes. This argument does not imply that the less competitive members are absolved from the responsibility of keeping their public finances in good order. It only argues that it is impossible for all EU members to run current account surpluses with each other at the same time. The less competitive members will be experiencing persistent current account deficits, which unless they get offset by transfer payments from the surplus members, they will eventually end up in financial crises.

B. Under the second scenario, EU leaders having failed to learn from their previous policy mistakes will insist on austerity, and other half measures which will prove to be grossly insufficient to stabilize the Greek economy. Greece will be in effect pushed out of the Euro-zone and forced to default on its debt. The following developments will provide evidence that this Euro-breakup scenario prevails: the debt restructuring will leave more debt than taxpayers can service. The continuous austerity policy will further depress economic activity. Private loan defaults and bank failures will drain any liquidity from the markets, and unemployment will increase to socially intolerable levels. In December 2011, the Greek youth unemployment was already at 47%, and it will deteriorate further. In other words, this scenario will result in pain and suffering for Greek people, with no end in sight and no hope for re-entering a growth trajectory any time soon.

Without the needed liquidity from the ECB, the credit crunch will cripple the banking industry and therefore the economy. To maintain a functional liquid banking sector, the Greek government will have to abandon the Euro and re-institute its own currency. The "new" Greek currency will be devalued immediately in currency markets, making the Euro-denominated debt unserviceable. Defaulting on all foreign-held government debt will be the next logical step. Domestically-held debt by banks, pension funds, and private investors will still have to be honored to avoid any more disruptions in the domestic market, but it will be redeemable at the new currency.

Certainly these transitions will not be without political and economic costs. Greece will be blamed for casting doubts in the feasibility of the monetary union and the much-desired hopes for political union of Europe. The transition to the new currency will require a bank holiday to re-configure hardware and software requirements, to convert all loan and deposit balances from Euros to the new currency, and to sufficiently recapitalize the banking institutions. Capital controls will have to be imposed initially to prevent the flight of Euros to other countries, while incentives will have to be provided for the private sector to convert their Euros into the new currency. For instance, discounts could be offered to those choosing to pay their taxes in Euros instead of the new currency. The devalued new currency will cause the prices of imports like oil, machinery, pharmaceuticals and other necessities to go through the roof, causing an unpredictable inflationary environment (Kondeas, 2011).

The transition will be painful in the short run, and the Greek people will undoubtedly be confused going from the depression of the EU/IMF plan to the high inflation of the new currency. But there will be light at the end of the tunnel. Without foreign debt payments, the Greek government will have an easier time balancing its budget without resorting to extreme austerity measures, which have been choking off the economy. Inflation will lift asset prices again creating more tax revenues from transactions. The weak currency will boost tourism and exports and result in job creation. With its own currency, the government could create the funds to initiate a domestic investment program to grow the economy, and at the same time increase the country's competitiveness.

At this point in time, Greece does not fully control its own destiny, like any independent sovereign nation should. It simply awaits decisions from Brussels to signal which of the two scenarios will prevail. If the EU leaders decide it is in the best interest of the EU to keep Greece in the monetary union, they will have to use all possible methods to help the Greek economy stabilize and grow out of its predicament. If they decide not to provide the necessary support now and in the future, then Greece will have no choice but to cut its ties with the Euro and pursue its own path to economic growth. In either case, the goal should be the growth of the economy and the prosperity of the people.

6. Developmental Strategies for Economic Growth

Based on the previous analysis, there are two main policy frameworks to promote growth and development for the Greek economy:[7]

A. The first one is a market-based framework, which is fully compatible with the current EU orthodoxy. This policy framework, better known as the "Washington Consensus", has dominated much of development theory and practice since the 1980s. The Washington Consensus can be summarized as macroeconomic prudence, domestic market liberalization and outward orientation. Other key aspects include minimal government intervention, the elimination of government subsidies and welfare payments, fiscal and monetary austerity, trade liberalization, privatization of state-owned businesses, and well-defined property rights (Williamson, 1989). Businesses and the economy benefit from long-term efficiency gains resulting from the liberation of market forces from the "straight jacket" of government controls. Economic growth under this framework is achieved from the allocation of resources and private investments in accordance with global market signals.

Unfortunately, under its current condition, Greece cannot reasonably expect that a wave of private investments will lift its economy out of the four-year recession it is undergoing. The Greek private sector is shrinking, industrial production is collapsing, and unemployment is expected to climb above 20% in 2012. Within such a dismal environment which is not conducive to private business initiatives, it is unrealistic and infeasible to expect that an influx of Foreign Direct Investment (FDI) will soon lead Greece to higher levels of economic growth. The labor costs are not yet competitive (Section-3), the corruption problems have not yet been resolved (Section-1), and the overall financial and political chaos that ensued from the financial crisis do not portray the country as a favorable and stable destination for international investments to take place. Perhaps in the future, once the structural reforms of the economy (Section-3) are fully implemented, Greece could be an attractive destination for private investment initiatives. Until then, the private sector alone cannot be expected to take Greece into a path of sustainable economic growth.

B. Whether the Euro zone decides it is in the best interests of the Union to keep Greece in its ranks and provides the necessary assistance and development funds now and in the future, or it decides not to do so and, consequently, Greece leaves the Monetary Union and prints its own currency to get access to funds, it becomes clear that for the foreseeable future the majority of potential investment funds will be coming from a government source. In the first case, the EU will have to allocate more investment funds for the purpose of arresting the free fall of the Greek economy and eventually jump start it. These funds would have probably been allocated to newer EU members to assist them with their integration to the union, but now will have to be diverted to existing member countries facing financial problems. While this may delay the EU expansion plans, it will be necessary to be done in order to ensure the cohesion of the Union. In this case, the Greek government and EU entities will have to oversee the allocation of funds to the most productive domestic investments. In the second case, where Greece has to print its own currency, the government will still have the role of formulating new plans and introducing new investments to return the Greek economy to growth. This clearly implies that a strategic partnership of public and private sectors as well as new state-societal alliances will be necessary to turn the Greek economy around.

Since both EU and state government funds have been allocated to the Greek economy in the past without any significant improvement in the country's international competitiveness, the solution cannot be just about more funds. The allocated funds will have to be invested smarter and will have to go to the most and best uses so that they will have the greatest economic, social, and developmental impact. First, to dispel concerns that the new investment initiatives will be hijacked by vested interests, the government must provide a "national purpose" framework which will bring together social and political forces in the interest of an economic development agenda. This growth-oriented restructuring of the Greek economy must lead in a strategic partnership between government agencies, forward-looking industries, and various social segments. Second, a prudent fiscal management will reorient government functions to achieve a "crowding-in" of productive investments that contribute to endogenous growth and competency. With a rigorous priorities formation, such a policy will ensure that the public purse is not wasted and that all investments are in alignment with the strategic objectives of economic development. Third, a system of accountability will be required by the Greek government, as the two forms of accountability, political and managerial, not only are tightly related but, more importantly, they have been consistently problematic in Greece. Consequently, improving accountability should be a specific goal of the move towards a purposeful development policy.

Since investment funds may largely come through EU and government sources,[8] the market and the state will have to successfully coexist and act as partners with one another to carve out their own spheres of competency and influence, and share in the benefits from their mutual collaboration.

In fact, the public and private sectors can cooperate in a range of different arrangements, each contributing what they do best, and both participating in the financial returns. A modern and intelligent Greek government that has learned from the wasteful mistakes of the past should find ways to ensure that the best business practices of dynamic and propulsive industries benefit the national economy. Such a government should take proactive measures, which require that dynamic firms use the allocated funds to invest in modern factors of industrial growth or *accelerators*, such as new production facilities, skills training and upgrading, and critical kinds of science and technology initiatives. Hence, particular emphasis needs to be placed on production-increasing and productivity-increasing investment spending on the accelerators of endogenous development, which will substantially improve industrial capability and competitiveness. State policy, on the other hand, should focus on technically proficient initiatives that allow industries to craft responses to changing market circumstances and translate industrial applications into commercial products.

In formulating policies for economic restructuring and diversification, it is critical that the policies are components of a long-term strategy. Failure to do so could lead both to short-run highly partisan considerations dictated by socio-cultural impediments and pressing problems (e.g., job creation, fiscal crisis, unsteady growth, balance-of-payments constraints), as well as the adoption of an *ad hoc* approach to development which is in conflict with the goal of a stronger economic fabric (Karagiannis, 2002). An industrial modeling and targeting plan requires a rigorous discussion of industrial planning and a detailed analysis of the selection process that clearly specifies benefits from certain economic engines that provide effective stimulus for industrial growth, rejuvenation, repositioning and overall competitiveness. Decisions relating to particular industries tend to have broader implications for the national economy as a whole, and require a clear delineation of the interacting influences between the promising sectors from the point of view of endogenous competency, and those that may provide short-term benefits but offer little hope as a secure basis for future national well-being.

Therefore, it is imperative to aggressively pursue advancement of certain dynamic sectors of high potential and feasibility such as solar, renewable and alternative energy, biotechnology, pharmaceuticals, information technology and engineering, tourism, hospitality, entertainment, and food and beverage, as there is potential to market opportunities for their growth, and these open up possibilities and set up incentives for a wide range of new economic activities. Targeting and support of these selected sectors, however, require detailed information on the quantity (*how much*) and quality (*what type*) of accelerators needed by these "economic engines" so as the quantitative and qualitative parameters of planned industrial investment are thoroughly taken care of.

Clearly, targeted industries will boost the structural transformation, production diversification and strategic repositioning of Greek economic sectors, and will develop and promote stronger inter-sector linkages with multiple short and especially long-run productive effects, resulting from investments in infrastructure and the industrial accelerators. Industrial targeting can be a realistic and feasible policy suggestion which will only require employment of existing resources in different ways, a rigorous system of checks and balances, a "wiser" public finance, and different government policy choices which are free of corruption and favor.[9] Industrial growth is expected to lead to a widening of the local market, which will bring about industrial competency upgrading and competitiveness improvement. After local resources are developed and put to use, changes in technology and production techniques will broaden the Greek production base, induce investment and effectively use resources to boost economic growth. Furthermore, inter-firm cooperation and coordination will help develop sector strategies and promote R&D and innovation, which will further encourage firms to learn to cooperate. The success of this developmental policy proposal, however, will depend on the quality of such policy intervention.

7. Conclusion

The Greek GDP grew for 54 of the 60 years following WWII and the Greek civil war. From 1950 until the 2008 economic crisis, with the exception of the relative economic slowdown of the 1980s, Greece consistently outperformed most European nations in terms of annual economic growth. Yet, social, cultural, and political factors have negatively affected the country's economic and business performance. The end result is the current financial crisis and debts of enormous proportions. However, the situation can be reversed if necessary social, political, and institutional reforms alongside prudent macroeconomic policies are aggressively pursued in a thorough and pragmatic way. Whether Greece leaves from the Euro zone or remains a part of it, these reforms will require a focused policy framework with a strong developmental dimension and market-augmenting industrial targeting.

It is really ironic that the Greek government, which has played a major role to the current financial crisis, will also have to be the agent that will initiate the new developmental agenda for the renewal of the Greek economy.

Notes

[1] It seems that Greek people's consciousness is influenced by their economic mode of existence. Also, culture, and in particular religion, exerts a causal effect on politics and the economy (whether the causality runs both ways is the subject of a long-standing debate in the social sciences, with Karl Marx and Max Weber among its most famous proponents).

[2] Some use the vulgar term "kleptocracy" (alternatively, "cleptocracy" or "kleptarchy", from the ancient Greek words κλέπτης (thief) and κράτος (rule): "rule by thieves") to describe a form of political and government corruption where the government exists to increase the personal wealth and political power of officials and the ruling class at the expense of the wider population, often without pretense of honest service. This type of government corruption is often achieved by the embezzlement of state funds (http://en.wikipedia.org/wiki/Kleptocracy).

[3] Surveys by Schneider and Enste (2000) and Schneider (2000) give existing evidence of the sizes of underground economies around the world and serve to indicate approximate magnitudes of the size and development of the underground economy, using the narrow definition. According to these estimates, two southern European countries, Greece and Italy, have an underground economy almost one third as large as the officially measured GNP, followed by Spain, Portugal and Belgium, with a shadow economy between 20-24 % of official GNP. The Scandinavian countries also have an unofficial economy between 18-20% of GNP, which is attributed mainly to the high fiscal burden. "Central" European countries like Ireland, the Netherlands, France, Germany and Great Britain have a smaller underground economy (between 13-16% of GNP) probably due to a lower fiscal burden and moderate regulatory restrictions. The lower underground economies are estimated to exist in countries with relatively low public sectors (Japan, the United States and Switzerland), and comparatively high tax morale (United States, Switzerland).

[4] According to Transparency International, Greece is ranked in the 49th place out of 146 countries in the Corruption Perceptions Index 2004, scoring 4.3. Although personal or other relationships should play no role in economic decisions, in societies like Greece this would conflict with generally accepted norms.

[5] The German government's deal with the labor unions to keep wages stable in exchange for job security increased productivity. In 2007, the German value added tax (VAT) was increased by 3%, while employer contributions for worker benefits were reduced. Such a policy of taxing domestic consumption, coupled with labor cost reductions further improved German competitiveness inside the EU and around the world. Germany's 2010 trade surplus of 7% of GDP exceeds the Chinese trade surplus of 4% of GDP.

[6] €70 billion EU institutional investors, €50 billion Greek banks, €40 billion EU banks, €30 billion Greek pension plans, €15 billion EU insurance companies.

[7] An old-fashioned state-led development framework is only a theoretical option but not a feasible and realistic proposal given the power of the EU supranational and other international institutions and the fact that the national government has lost significant policy space during this challenging era of globalization.

[8] To be more precise, investment funds can come through EU sources, from EU and Greek banks, from private business (local private initiatives and FDIs) and, perhaps, to a lesser extent, from the Greek government and public sector.

[9] A "new look" Ministry of National Development (or Ministry of Investment, Industry and Trade) is absolutely necessary to thoroughly formulate and effectively implement development policy in Greece. Such a powerhouse should be free of corruption, dedicated to raising both the quantity and quality of investment and boosting industrial growth, endogenous competency and competitiveness. Its core planning staff should consist of a small, entrepreneurial team rather than a vast bureaucracy –squandering resources over a whole range of bureaucratic activities must be avoided. The team should be recruited partly from within the Greek executive administration but also from business, professionals, and the academic and scientific world: a "new look" Ministry would need some well-educated, well-trained, and efficient technocratic planners. With the participation and assistance of consultants, advisors and experts from the EU, the government forms a consensus on the best policies to pursue. Economic policy should be built in close coordination between the Ministries of Finance and of National Development: the former with a relatively short-term demand perspective; the latter with a longer-term supply perspective. The new Ministry will have to be organized around the requirements of an accountable strategic planning agency with a long-term commitment and the powers and determination to intervene decisively and take the necessary policy action.

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