



*Addressing the Greek Crisis and the Balance of Payments Crisis
in the Mediterranean countries*

*Document based on paper presentation by Jacques Delpla,
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1) The Greek crisis is part of a larger and deeper Balance of Payments (BoP) crisis affecting most of the Mediterranean countries of the Eurozone (Greece, Portugal, Spain, and to a lesser extend Italy)

Mediterranean countries have used, since 1998, the windfall gains of lower interest rates to consume. Their prices and wages have grown much faster than productivity. In all of the Mediterranean countries the unit labour cost has grown since 1998 much faster than in Germany or France, without parallel increase in productivity (according to the OECD). The countries have lost relative competitiveness and, as a consequence, have been running huge current accounts deficit since the early 2000s. The present budget crisis and the interest rates increase are not accidents. They derived from that structural situation.

The Greek crisis is also the crisis of all countries that have lent to Greece (foremost France and Germany).

The Mediterranean countries need to restore competitiveness. If they were outside of the Euro they would have to devalue their currency by 20% to 40% to restore their balance of payments. As devaluation is no more an option, competitiveness has to be restored by wage and price cuts, and supply side measures, all largely difficult and unpopular.

If the needed cure of austerity is imposed without external help it has few chances to be politically sustainable. Populists will call for debt default and exit out of the Eurozone. Pure market based adjustment is doomed to fail. Imposing deflation policies (cuts in wages and prices by 20%) in a recession period is extremely difficult. Unemployment may rise to 20%. Latvia in 2008 was courageous enough to start such an adjustment, but with a lot of political risks associated with that move. Without strong outside support, governments in charge may be unable to develop a large consensus on the reform with all the moderates, and may be kept hostages by populists, trade unions and left-wing forces.

2) **A default by Greece is not an option for the EU**

If Greece decided to default on its public debt, the Greek banking sector would melt down, external financing would evaporate, the private sector would collapse as a result of a complete credit crunch. Greece would then experience a massive and lasting recession.

If Greece defaults, the credibility of the Euro will be at risk, investors will fear that the other Mediterranean countries may follow the same path. They will be attacked by speculators and their interest rates spreads with Germany will increase. The Greek default will not be the end of the Greek crisis, but the beginning of a wider crisis of the Eurozone as a whole.

If Greece defaults it would destroy German markets, alienate other Europeans against the countries that refused to support Greece, increase risks of recession throughout the Eurozone. Germany or France, as lenders, would have to recapitalize further their banks affected by the crisis.

EU must help Greece to fund its public debt during the reform: private debt needs restructuring, public debt needs to be repaid, with the external help of the IMF and the EU. This assistance should come with stronger conditionality.

One should not underestimate the effort needed from Greece. Greece has to:

- reduce the budget by 10-12% in quick time (5 to 7 years) ;
- reduce demand through higher VAT, higher taxes on housing, properties and land,
- restore the credibility of the tax system,
- establish a credible stringent binding fiscal rule in their constitution (on the German model).

One should not underestimate the effort needed from the EU: on the side of national bilateral loans, the resources needed to support Greece (and may be other Mediterranean countries of the Eurozone) during the reform will require an increase of the European Budget (up to 1,27% of the European GDP) and a new reform of Structural Funds to channel a part of the common effort for Greece and to the MEDs through them.

3) **Structured exit strategies for the Mediterranean countries**

Academics are investigating exit strategies out of the crisis of the balance of payments of the Mediterranean countries and for more incentives for fiscal discipline in the Eurozone

Blanchard has advocated a quick **coordinated "internal devaluation"** through government imposed cuts in prices, wages and social benefits + temporary freeze of wages and prices + reduction of private debt and restructuring under a national banking law + massive supply side reforms.

According to **Algan**, and the economists of confidence building, supply side reforms may go together with more flexibility in the labour market (with financial provisions for retraining periods) and more equally distributed social benefits.

Many economists also stated the long term benefit of the new **German constitutional rule on budget deficit**.

Von Weizsäcker and Delpla advocated as soon as in May 2009 (EIN Meeting in Paris) to create in each country a senior (blue) and junior (red) debt country. A European unified market of Blue Debt Market could be created, deep and liquid (6000bn Euros). Only countries that respect strict rules will be allowed to issue Blue Debt Bonds. That system would be much cheaper than the establishment of an EMF.

Some contributions to those discussions are to be found in *Putting People in the Heart of Europe, the Basis for Recovery, Proceedings of the EPP Group Summer University organized by the European Ideas Network*.

Jacques Delpla's complete PowerPoint presentation is available on the EIN Website.

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