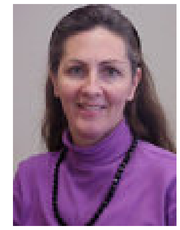
Greece illustrates the importance of staying within economic limits



What lessons can Greece provide with a view to preventing future debt crises? **Carol Osler** *writes that the Greek debt crisis illustrates the importance of staying within economic limits. She notes that while it is impossible to ensure countries will always be financially responsible, well-run societies should aim to protect citizens from the dangers associated with excess government debt.*

The tragedy playing out in Greece demonstrates a critical lesson about economic limits. Countries naturally face a limit on their sustainable standard of living. Likewise they face limits on government debt, on sustainable money growth, and on the losses their banking system can sustain without collapse.

Economic limits are intangible and sometimes hard to understand. Nonetheless, they are always quietly at work. The suffering in Greece today shows that crashing into these limits can bring painfully tangible consequences. It also dramatises the value of protecting society from these common economic mistakes.

Act I: Limits on standard of living and government debt

As is now well known, Greece has lived beyond its means for decades, aided and abetted by its government. The government taxed people at low rates and tolerated rampant tax avoidance, so revenues were low; meanwhile pensions and services were supported at the generous levels common across Europe. From 2001 to 2007 government revenues averaged just 39 per cent of GDP while spending averaged 45 per cent of GDP. Year after year Greece borrowed on world capital markets to fund the resulting deficits.

The Greek approach to fiscal management naturally brought prosperity: GDP grew by 4.4 per cent on average between 1994 and 2007, an enviable record for any developed economy. But the prosperity that comes with living beyond your means is as fragile as a house of cards. And like a house of cards, that prosperity inevitably collapses.

By 2010 Greek government debt exceeded 150 per cent of GDP. The country's creditors lost confidence that they would be paid back and Greece could no longer borrow on world capital markets. Greece had crashed into limits on both its standard of living and its government debt, so its house-of-cards economy collapsed. GDP has fallen 25 per cent from its 2007 peak and unemployment has risen to 25 per cent.

Some pain from economic downsizing cannot be avoided. No hero, no magic government policy, can put the house of cards back together again. The best a government can do is moderate the pain, but even here Greece had few good options. IMF research shows that downsizing after government excesses is less stressful if the government reduces spending rather than raising taxes. Unfortunately, Greece's main problem was low taxation.

In other countries the pain of downsizing has often been moderated by a currency depreciation, which stimulates exports, but Greece can't change its exchange rate because it relies on the euro, a shared currency. The pain can also be moderated by structural economic reforms, such as privatising state-owned enterprises or eliminating restrictions on competition. Such reforms, which raise long-run economic growth, are acutely needed but unpopular with Greek voters.

The severity of downsizing is also influenced by the extent of previous excess. Greece's excess grew to outsized proportions because its initial adjustments were weak and ineffectual. In 2004, with government debt at roughly 100 per cent of GDP, the European Commission issued a stern warning about the need to put their fiscal house in order. The government raised taxes and trimmed spending but the measures were too modest. Its deficit remained above 5 per cent, far in excess of the Eurozone's maximum allowable rate of 3 per cent. During the financial crisis the deficit widened further, reaching a heart-stopping 15.7 per cent in 2010. That was when creditors simply stopped lending.

Act II: The plot thickens

In desperation, the government turned for help to fellow Europeans, who made a big loan and effectively forgave some existing debt. They also insisted, however, that Greece reform its government finances and implement important structural reforms. Greece has fulfilled many, though not all, of these conditions.

Initially these reforms were met with frequent strikes, some of which turned violent, but eventually the Greeks accepted the need for retrenchment. Nonetheless, the depth and duration of the adjustment took them by surprise and after three years many voters were convinced they had suffered enough.

In late 2014 Alexis Tsipras' Syriza tapped into public sentiment by promising to relax the austerity measures. But economic limits are mathematical; they do not respond to human suffering. When the new government relaxed austerity as promised the limit on government debt was still there. Tsipras suspended privatisations, raised the minimum wage, and restored some pensions, all of which used government cash.

By late spring the nation's coffers were depleted and the government – again – needed extra money. But of course Greece could no longer borrow on world markets. Greece once again turned to other Eurozone countries for help and they once again demanded structural reforms. Tsipras negotiated aggressively but his tactics sent Greece careening into a new set of economic limits.

Enter the banks

A quiet run on Greek banks had begun earlier in 2015. It was not a crisis situation because the ECB was providing Emergency Liquidity Assistance. Tsipras unexpectedly stopped the negotiations to enable a referendum, however, and the ECB responded by halting further increases in Emergency Liquidity Assistance. This increased the likelihood that Greek banks would begin hitting their cash limits, which intensified the bank run. Once again, Greece had discovered a limit the hard way, this time a limit on bank liquidity.

Desperately attempting to avoid a liquidity crisis, Tsipras imposed capital controls and cash withdrawal limits. These did stop the bank run but they also discouraged tourism and much business activity. Loan defaults quickly accelerated and the banks were losing money rapidly. If the banks lost too much money they would have ceased providing credit and the economy would contract further.

But to keep lending the banks needed a large infusion of funds, and Parliament was out of money. Greece's central bank also couldn't help because in 2001 it had assigned all power to create money to the ECB. The country was discovering another limit the hard way – the limit on bank solvency. And did I mention that Greece could no longer borrow on world capital markets?

Act III: Cornered by limits

By crashing Greece into one economic limit after another Tsipras had intensified the country's need for Eurozone credit. First Greece needed cash to keep the government running, then it needed ECB liquidity support, finally it needed funds to keep the banks in business. And it needed all these funds urgently.

Tsipras' approach effectively boxed Greece into a negotiating corner, so he ultimately accepted all the conditions demanded by his fellow Europeans for their financial support. Fortunately, these conditions largely involve structural reforms that benefit everyone by enhancing Greece's long-run economic growth. Europeans will benefit because more of their loans to Greece will be repaid. The Greeks will benefit from a stronger economy.

The nadir of this tragedy may have passed. The Greek government got some cash and the Greek banks received liquidity support and a cash infusion. The Greek Parliament has enacted many long-delayed structural reforms. And once Greece's economic policies are in line with those elsewhere in Europe, its creditors may ease the repayment terms.

What can we learn from this tragedy? One obvious lesson is that financially responsible countries must heed warnings and avoid limits. But let's face it: Humans often learn by crashing into limits. That's how many of us discover the limits to our driving skills, right? Well-run societies protect their citizens from the dangers of crashing into limits. To protect us on the road, for example, societies place protective barriers along highways.

Well-run societies likewise protect citizens from the dangers of crashing into economic limits. To ensure they do not print excessive money, for example, countries routinely adopt inflation targets and insulate their central banks from political interference. Economists are still searching for wise approaches to protecting countries from excess government debt and from limits on the banking system. Greece's experience highlights the importance of that search.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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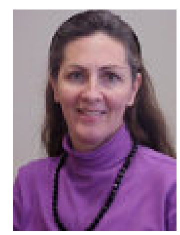

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