International warning: IMF Executive Board Member Miranda Xafa says urgent action is needed if Greece wants to get its economic house in order

Highway to (fiscal) hell

International Monetary Fund Executive Board Member Miranda Xafa warns of a bleak outlook for the Greek economy unless urgent action is taken to make essential structural reforms

After taking a toll on many of the world's leading economies, recession appears to be knocking on Greece's door, at a time when ballooning deficits limit the country's ability to take countercyclical action to bolster the economy. In an exclusive interview with *Business File's editor-in-chief Philip Pangalos*, IMF Executive Board Member Miranda Xafa, a former economic advisor to the New Democracy government of Constantine Mitsotakis in the early 1990s and a former senior analyst and strategist at US investment bank Salomon Brothers, warns of the imminent dangers facing the Greek economy.

Mounting economic problems, exacerbated by the global slowdown, and the need for essential structural reforms were the main reasons given by Prime Minister Costas Karamanlis for his decision to call early elections on October 4 as he seeks a fresh mandate to tackle Greece's mounting economic woes. IMF Executive Board Member Miranda Xafa, who has had a distinguished career, garnering respect from the international financial community, tells *Business File* what she thinks needs to be done if Greece really wants to get its economy back on track and avoid the potentially more serious consequences that lie ahead if action is not taken soon.

Q. What are the main problems currently facing the Greek economy and what in your opinion needs to be done to address them?

A. The financial crisis intensified dramatically a year ago, after the bankruptcy of systemically important Lehman Brothers and the near-failure of insurance giant AIG, triggering a global downturn. As a result, the Greek economy is expected to record zero growth this year, and to recover only modestly in 2010, with the risks tilted to the downside. This performance reflects the deterioration in global economic conditions that led to a decline in Greece's exports, consumer confidence and business investment. But the global crisis also brought to the surface the structural weaknesses of the Greek economy. During the upswing, per capita incomes in Greece converged almost fully with the EU average, but convergence was achieved by borrowing and by allowing real wages to rise faster than productivity. Externally-funded credit growth fueled a housing and consumption boom, public spending rose and competitiveness deteriorated. Until recently, strong external demand and low interest rates masked the deterioration in competitiveness and the increase in both public and private debt. These weaknesses have now come to the surface and need to be urgently addressed before growth can resume. With national income stagnant and government bond yields at 5%, the debt dynamics have become explosive. Interest payments on the public debt are on a rising trend, now absorbing more than 10% of Greece's annual income. And annual income cannot recover if the economy is not competitive. Rising debt service payments with stagnant incomes - that's the trap in which Greece risks getting caught.

Q. Are you satisfied with the fiscal measures already announced by the Greek government?

A. The measures announced in March and in June are stop-gap measures aimed at containing the fiscal deficit through one-off revenues and a freeze in government salaries above a certain threshold. They do not reduce public spending on a permanent basis, and thus have no lasting impact on the public debt burden.

Q. What measures are needed to address Greece's ballooning debts and deficits?

A. Greece entered the global downturn with an already weak fiscal position and rising debt burden. What is needed is a drastic cut in public spending and a broadening of the tax base through high-quality, durable measures. A medium-term fiscal plan needs to be drawn that will place the public debt firmly on a downward path. The government that will emerge from the October elections should seek the support of all political parties for the fiscal plan, which should be implemented irrespective of who is in power. Compliance with the plan should be monitored through high-frequency, publicly announced targets, such as the number of civil servants (monthly) and the financial statements of public enterprises (quarterly), and corrective measures should be taken if the targets are missed. The IMF has recommended a 5-year plan to eliminate the operating deficits of public enterprises through restructuring or privatization. There is also an urgent need for a major pension reform that will reduce significantly the unfunded liabilities. Defense spending and health care are also "black holes" of government waste. On the revenue side, there is an urgent need to improve tax administration along the lines recommended by the IMF back in 2005.

Top team: IMF Executive Board Member Miranda Xafa with Paul Volker, former Federal Reserve chairman and economic advisor to US President Barack Obama

Q. What needs to be done about Greece's bloated public sector and inefficient public governance?

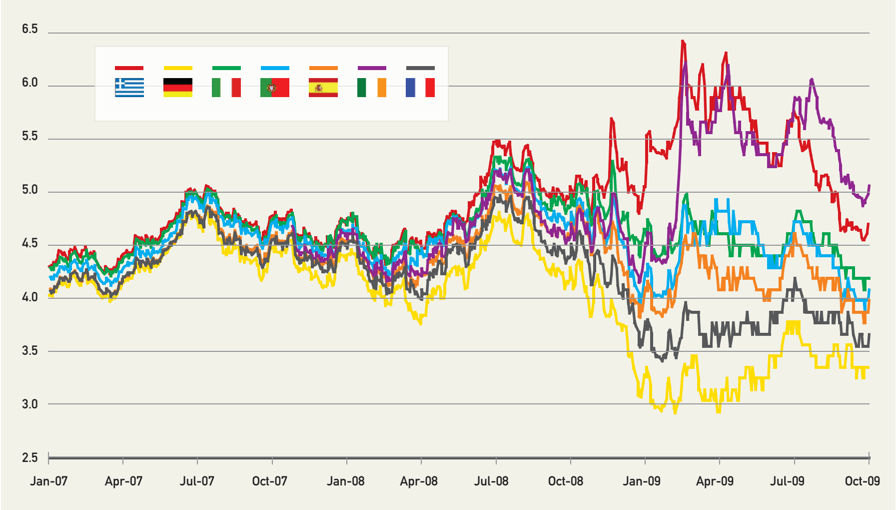
A. There is no shortage of ideas. A good place to start would be to make the budgetary process more transparent and the government more accountable. Program budgeting should be introduced to make it possible to evaluate the impact of government programs on education, health, poverty reduction, etc. To increase the efficiency of spending, the new government could establish a high-level Economic Council, chaired by the Prime Minister, to overhaul the social safety net and subsidy schemes, direct or indirect. In this day and age it is ridiculous to have the "unmarried daughter" collect the father's pension while the "unmarried mother" receives no government support. It is equally ridiculous for Greece to have more newspapers than the United Kingdom, subsidized through opaque tax benefits and advertisement revenue from public enterprises. There is also a need to codify the maze of legislation regarding tax and pension issues, so as to clarify and simplify the legal framework. A similar initiative was undertaken by the Reagan administration, which appointed a Sunset Legislation Commission chaired by the Vice President to come up with proposals to abolish obsolete pieces of legislation.

"With national income stagnant and government bond yields at 5%, the debt dynamics have become explosive"

Q. How do you think that Greece should best tackle the looming pensions time bomb? What do you think should be done to address this issue amid a worsening demographic climate with an ageing population and falling birth rates?

A. Greece has the highest long-run aging costs in the Euro area. Reform is hampered by the fact that the pension system remains incredibly fragmented, inequitable, and chaotic even after the 2008 administrative reform. Pensions are not closely related to contributions, as pension benefits, contributions and retirement age differ widely across different funds. Public sector pensions are well above those of the private sector, as the politically powerful public sector unions managed to obtain excessive benefits relative to their contributions. These taxpayer-subsidized public pension funds need to be reformed. What is needed is a fundamental reform, involving equal contribution rates and replacement ratios (i.e. pensions relative to salaries) for all workers, both in the private and public sectors. Regarding the retirement age, some flexibility could be provided by permitting early retirement at a lower, actuarially fair, pen-

Rising concerns over fiscal sustainability...
10 Year Government Bond Yield



sion. At the same time, the government should encourage contributions into private pension funds by making them tax-deductible. In contrast to the existing state-run, pay-as-you-go bankrupt pension system, a fully-funded private pension system can eventually provide significant supplementary pensions because its financial health does not depend on demographic developments.

Q. Does Greece's high public debt limit its ability to take counter-cyclical action?

A. The government depends on investors' willingness to finance its deficit and to roll over the debt that is maturing. Investors are only willing to finance the government if they think that it will be able to meet its obligations in the future. Greece's high public debt burden implies that a countercyclical fiscal stimulus would risk having a devastating effect on the cost and availability of financing. Any attempt to use fiscal policy to support growth could thus backfire. Conversely, the confidence-building impact of a fiscal tightening that helps ensure debt sustainability can have a high payoff by ensuring that financing will continue to be available to support growth. To the extent that it builds confidence, fiscal adjustment can be expansionary.

Q. Can Greece escape the EU's excessive deficit procedure?

A. Greece should not try to escape the EU's excessive deficit procedure. If it did not exist, we should invent it! It seems to be the only means of convincing the Greek political system to follow a prudent fiscal policy.

Q. Has Greece's membership of the Euro zone shielded it from a much more severe fallout from the global economic slowdown than has been felt so far?

A. There is no doubt that the Euro provides a tremendous shield. EU-member countries that are outside the Euro-area have been hit by the crisis much harder than Greece. Hungary, Romania and other countries with better fundamentals than Greece lost access to international capital markets and received emergency assistance from the IMF. By contrast, Euro-denominated Greek government bonds remain attractive to investors –though at a much higher spread than before the crisis– because they provide access to cheap funding from the ECB through repo transactions. But, Greek bonds risk becoming less attractive to investors when the ECB eventually raises its repo rate. With financing pressures likely to increase over time, it is imperative to put the fiscal house in order.

Q. Is there any real danger of Greece defaulting on its financial obligations?

A. It is not inconceivable that, if the deficit is allowed to increase further, a Greek bond auction might fail to raise the needed funding. Such a development could trigger a massive sell-off of Greek debt that could cause the credit spread to spike. Obviously, such an event should be avoided at all costs to safeguard financial stability in Greece and in the entire Euro area.

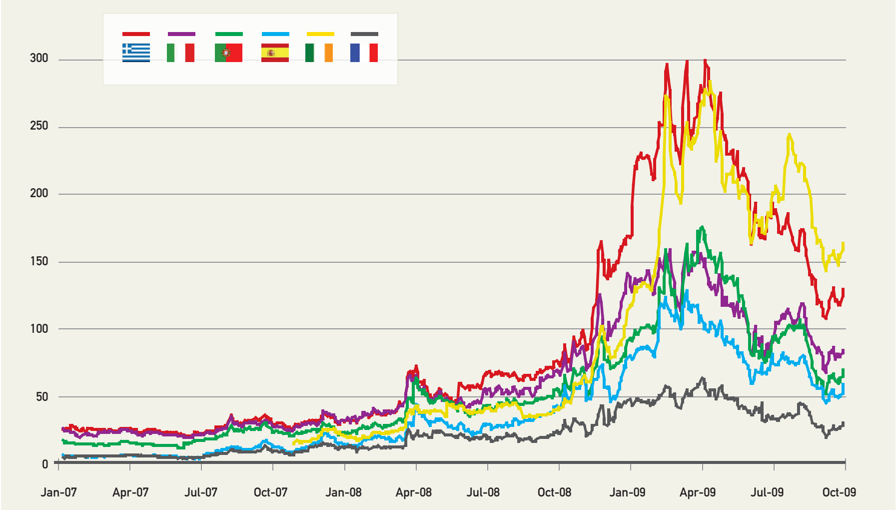
Q. Would the IMF step in and under what circumstances and conditions?

A. The Euro area prefers to "take care of its own". There was some reluctance on the part of the EU to have the IMF involved in bailing out EU countries that are outside the Euro area, such as Hungary, Romania, and Latvia. However, the IMF's involvement turned out to be indispensable, given the extraordinary economic and financial events of the past year and the IMF's unique expertise in designing and monitoring adjustment programs. So far, however, no Euro area country has ever turned to the IMF for a loan.

Q. How concerned are you about possible exposure of Greek or other European banks to eastern European and Balkan markets?

A. Greek banks have significant exposure of

...are reflected in wider spreads over Bunds
Spreads From the 10-Year German Bond Yield



about 50 billion to the Balkans and Eastern Europe. Although this region has been the hardest-hit by the crisis, Greek banks do not plan any mass withdrawal since longer-term they see opportunities and intend to maintain a presence there. Austria has by far the biggest exposure to the region. Risks have increased but they remain manageable. Although subsidiaries fully hedge their foreign exchange exposure, foreign exchange risk could turn into credit risk in the event of large currency movements. Greek banks have recently been able to raise capital in the market, helping them to absorb these risks. And the IMF provides financial and policy support to countries in the region, thus helping them reduce credit and foreign exchange risk.

Slow motion: IMF's Miranda Xafa expects the pace of global recovery to be slower than in past recessions

Q. What do you see as the main priorities to help make the Greek economy and labor market more competitive?

A. The main priorities are to (a) divert resources away from loss-making public enterprises toward productive uses; (b) reduce government waste and red tape; (c) promote labor market flexibility by spreading the use of part-time employment, reducing employment protection, and decentralizing the wage-setting process, so that loss-making companies are not bound by any national wage agreement; (d) open up the "closed professions", in line with the EU Services Directive. In fact, Greece should go beyond the EU requirements and liberalize trucking, which raises considerably the cost of transporting goods. There could be a "social contract" between employers and labor unions, with job creation in exchange for wage moderation.

Q. The Greek government has said that it is on course to meet its privatization targets that are expected to generate 1 billion euros this year. Do you feel that the government's privatization plans are adequate?

A. The purpose of privatization is to make entire segments of the economy function more efficiently, not to raise revenue to plug the budget gap. Privatization revenues are one-off revenues that should be used to retire public debt, not to fund recurrent expenditures. Greece's privatization program is "too little, too late" relative to the rest of the EU. It is inexcusable to have allowed Olympic Airways to waste billions of taxpayers' money while distorting competition in the airline sector by relying on government handouts for so long. The government should get out of the business sector altogether, including the transport sector, electricity generation and telephone services. It is entirely unclear why it keeps minority stakes in casinos and other sectors where the government has no business whatsoever.

Q. Some say that global economic recovery could be 'W' shaped. Do you agree?

A. I think the recovery is more likely to be U-shaped, with the pace of recovery slower than in past recessions because financial systems are still impaired, and consumers have less access to credit while struggling with high unemployment. Moreover, extraordinary fiscal and monetary stimulus will gradually have to be withdrawn when the recovery takes hold.

Q. When do you expect to see a recovery from the downturn in the global economy and Greece at a time when the country faces recession for the first time in 16 years?

A. Greece entered the global downturn in slow motion, because its financial system was not impacted by any "toxic assets" in the early stages of the crisis, and exports were only hit at a later stage, when the financial crisis was transmitted to the global economy. The fact that Greece is a relatively closed economy with a "plain vanilla" financial sector was a positive factor, as its economy was not as hard-hit as export-oriented countries with sophisticated financial systems like Germany or the UK. However, in order to benefit from the eventual recovery in global growth, Greece needs to take immediate action to reverse both the unsustainable rise in public debt and the erosion of competitiveness. In its absence, Greece risks getting trapped in a low-growth equilibrium. ✖

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