# Reform or die

*In an exclusive interview with* Business File, *Miranda Xafa says bold actions are needed for Greece to exit the fiscal crisis with more effective structural reforms and measures to improve competitiveness*

**To sum up**

**As Greece struggles to exit an economic and fiscal crisis that has pushed the country to the brink of disaster with a recession in its sixth straight year and record unemployment, *Business File's* editor-in-chief Philip Pangalos posed a series of questions to Miranda Xafa, CEO of EF Consulting, an Athens-based advisory firm focusing on the eurozone economy and financial markets. Xafa is an internationally-respected economist who started her career at the International Monetary Fund in 1980 and eventually became IMF executive board member in 2004-09, representing Greece and six other countries. She has also been a former economic advisor to the New Democracy government of Constantine Mitsotakis, as well as a senior strategist at US investment bank Salomon Brothers and Citigroup.**

When ***Business File*** last carried an exclusive in-depth interview with Miranda Xafa four years ago, she warned of the imminent dangers that lay ahead if urgent action was not taken to tackle a longstanding series of economic ills and implement urgent structural reforms to correct them. Our cover story at the time (September-October 2009 issue) ran with a title of *Highway to (fiscal) hell*... Her frank warnings couldn't have been nearer the truth. Months later the fiscal crisis had engulfed Greece, frozen the country out of debt markets and eventually required two international bailout loans to avoid a sovereign default and the unthinkable possibility of a forced exit from the eurozone. *Business File* posed another series of questions to Ms Xafa on September 11 and her to-the-point answers are as telling as ever.

**With the Greek economy already in a sixth straight year of a deep and prolonged recession and record unemployment, have the austerity measures prescribed by the country's international creditors in return for the two bailout loans been a mistake? Have they made matters worse, as some would argue, or is the fact that structural reforms and privatisations have been delayed a bigger part of the problem?**

Austerity measures and recession were inevitable in an economy that had gone on a debt-financed spending spree for decades. But the recession would not have been as deep and prolonged if (a) the economy were more flexible, i.e. if wages and prices adjusted faster to the decline in demand; (b) the stabilisation program had relied more on spending cuts and less on tax increases; and (c) the privatisation program had started sooner and was more ambitious. But there was strong pushback in all of these areas from the Greek political establishment. There was strong resistance to reform in politically-sensitive areas like opening up the professions, downsizing the public sector, and privatising public sector companies that politicians viewed as their fiefdom. The recession would not have been so deep if the government had tackled these three areas up front. Instead they kept bombarding the private sector with taxes to preserve the bloated public sector.

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**Were the targets for reforms and privatisations too ambitious in the first place? Who is to blame?**

Greece was the most highly regulated economy in the OECD. Profit margins or minimum remuneration were set by law in a number of professions (lawyers, engineers, accountants, pharmacists), and licensing requirements imposed barriers to entry in others (trucking). Labour contracts set wages on automatic pilot due to seniority clauses and other benefits unrelated to productivity, profitability or performance. No amount of currency devaluation ever got rid of these distortions. Greece has a domestic competition problem which affects external competitiveness. Appropriately, the EU/IMF-funded programme included broad-based structural reforms intended to introduce flexibility in labour markets, intensify competition in goods and services markets, and open up the professions. Obviously strong interest groups opposed these reforms and slowed down their implementation, so the reform process has been protracted and politically difficult.

Danger warning: Miranda Xafa warns that any return to the drachma would lead to "economic chaos and social explosion", adding that it could happen if Syriza comes to power and official creditors, including the ECB, decide to pull the plug

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

The key problem is competitiveness. The World Economic Forum's Global Competitiveness Report 2013-14 shows that Greece remains the lowest-ranked country in the EU, with an overall rank of 91 out of 148 countries, below some sub-Saharan countries. Inefficient government bureaucracy, tax rates and regulation, and policy instability remain the most problematic areas, together with lack of financing. Greece ranks 144th out of 148 countries in terms of the burden of government regulation, 140th in the wastefulness of government spending, and 138th in the efficiency of the legal framework in settling disputes. Growth and jobs require investment, and investment will not rebound unless competitiveness improves. The privatisation programme can contribute significantly to the recovery of investment in an environment constrained by a shortage of bank financing.

**What else needs to be done to restore credibility and how long will this take?**

Fiscal consolidation is not yet complete and more needs to be done to cut wasteful government spending and lower taxes. The pension and health systems need further reform to be viable, and administrative reform has only just begun. Even if a primary surplus is achieved this year, it will not be sustainable without further reform. Recall that three years' property taxes were collected this year, while public investment was 1.5 billion euros below target in the first eight months of the year. Besides, producing a primary surplus is not enough: the surplus needs to be high enough to cover interest payments, which will amount to 9-10 billion euros in the next few years, for the debt ratio to be on a firmly downward path.

**When do you think that Greece can again realistically return to international debt markets with a bond issue? Is 2014 a realistic target and at what estimated interest rate?**

The 10-year Greek government bond currently trades at a yield of nearly 10 per cent which is prohibitive, even if Greece could tap the bond market, and well above the cost of borrowing from official sources. I believe Greece will be able to re-access capital markets at a reasonable cost only after it has achieved a significant primary surplus and the debt ratio is on a firmly downward path. I also doubt official creditors would let Greece undertake significant new debt service obligations while large redemptions of official loans remain outstanding.

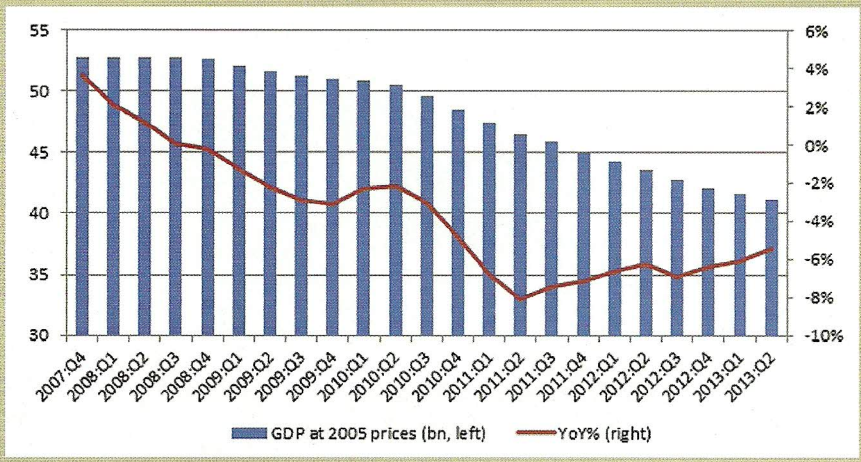
**Is Greece's public debt sustainable? What has to be done to make it sustainable? Is this realistic?**

The public debt ratio at year-end will exceed 170 per cent of GDP, the level reached at the end of 2011. Back then, the debt was considered unsustainable and discussions for a debt write-down (PSI) were underway, so I doubt that a public debt ratio of 176 per cent at end-2013, as projected by the IMF, can be considered sustainable. It is true that interest payments have been reduced significantly as a result of the PSI and the subsequent debt buyback, which extinguished 61bn euros of debt (31 per cent of GDP) in net terms, i.e. after taking into account the collateral damage on bank balance sheets, the "credit enhancement" through EFSF bonds required for the PSI, and the funding needed for the buyback. The postponement of interest payments to the EFSF/ESM, and the reduction in the interest margin on the bilateral loans that funded the first rescue package, further reduced debt service obligations last year. Even so, Greece is unlikely to sustain a primary surplus of at least 4 per cent of GDP at least until 2030, as required for the debt ratio to fall below 100 per cent of GDP, so I believe that debt relief in the form of a haircut on official debt will be needed. Including the "old" Greek government bonds held by the ECB and national central banks, which were not subject to a haircut, Greece's debt to the official sector amounted to 80 per cent of total public debt in mid-2013.

**Do you think that there will be a need for more austerity measures? How will this go down with the Greek people and how will it affect the coalition government?**

I do not believe austerity measures in the form of across-the-board cuts in salaries and pensions are needed. What is needed are targeted interventions in the areas of tax administration, pensions, health and administrative reform to improve tax collection and weed out wasteful government spending, as well as a ›

**Greece quarterly GDP (4Q moving average)**




Source: *Business File*

continued effort to improve the entrepreneurial environment. It's worth stressing that those who call for an end to austerity believe that expansionary fiscal and incomes policies will trigger a recovery of economic activity. But it is always an illusion to believe that governments could stimulate demand and thereby induce producers to produce more. Governments can only shift resources from those who have created them to those who haven't. If the economy is not competitive, the stimulus will not elicit a supply response but will instead leak abroad in the form of increased imports.

**Are you optimistic or pessimistic about Greece's prospects in the near and medium term?**

The picture is mixed. Early signs that the recession has bottomed out are contributing to improved confidence. Fiscal consolidation is advancing, credit spreads have declined sharply, bank deposits have increased, economic sentiment is improving, the pace of job losses is slowing, and several Greek companies have recently accessed markets. At the same time unemployment is stuck at 27 per cent, public debt is very high, competitiveness is improving very slowly, and many structural reforms are still ahead of us. It is disappointing to see the government trying to tackle unemployment through stop-gap measures like EU-funded hiring of temporary workers in the municipalities, instead of using these resources to subsidise hiring in the private sector, where these workers might actually learn something and possibly get a permanent job.

**Is there still a danger that Greece may one day be forced to leave the eurozone? How likely is this? How can it be avoided?**

Leaving the eurozone would make absolutely no sense. No country has ever devalued its way to prosperity. Imbalances and distortions that plague the real economy cannot be addressed through monetary tools. The bloated protected, non-traded goods sector in all southern European economies can only be addressed through structural reform, not through monetary reform. Greece's loss-making public sector companies need restructuring and privatisation, not devaluation. Moreover, if Greece drops out of the eurozone, the inevitable adjustment to a lower standard of living will be unfairly distributed because it will happen through inflation. Low-income earners are the most exposed to inflation because they do not possess foreign bank accounts or other inflation-protected assets. The redenomination of all contracts from euros to drachmas is tantamount to expropriation of savings, while large debtors will benefit. It is also doubtful that Greece would attract much investment from abroad. Who would guarantee the stability of the drachma after its devaluation? Surely not the same political system that brought Greece to the brink of disaster. No Greek exporter, hotel, or restaurant will convert euro income into drachmas, knowing that the drachma tomorrow will be worth less than today. The drachma would be the main currency for government employees and pensioners only. The result would be economic chaos and social explosion. It could happen if Syriza comes to power and official creditors, including the ECB, decide to pull the plug.

**How badly have relations between the EC and IMF been damaged over the Greek debt sustainability issue? Was the recipe wrong and who is to blame?**

I think many analysts realised early on that the Greek debt is unsustainable. But in the spring of 2010, when a large rollover of Greek government bonds was falling due, no one – neither policymakers nor market participants – was ready to discuss a haircut on the debt. You may recall European Central Bank resident Jean-Claude Trichet at the time saying there would never be a debt restructuring in the eurozone. So, as the IMF admitted in its ex-post evaluation, the first rescue package was a holding operation intended to prevent contagion to the rest of the eurozone despite the fund's misgivings about Greek debt sustainability. The choice in May 2010 was to either let Greece default, with dire consequences for the rest of the eurozone, or step in and offer assistance despite doubts about debt sustainability. As it turned out, the implementation of the programme by the Greek government left much to be desired and the external environment turned out much worse than expected, as the eurozone, which absorbs one-half of Greece's exports, suffered two consecutive years of negative growth in 2011-12. These developments sealed the fate of the programme and made a debt write-down necessary in March 2012. A second programme was agreed at the same time but the two elections in May-June 2012, and protracted coalition negotiations after that, drove the programme off track again.

**What do you think will happen after the forthcoming German elections as far as Greece is concerned?**

I think that the Germans will eventually recognise that the Greek debt is unsustainable and will agree to a haircut on official debt, provided Greece continues to implement the programme. I do not believe the Germans will back down from their view – which I consider to be correct – that any relaxation of fiscal discipline and reform momentum in the European South will weaken the entire eurozone.

**On the issue of the so-called brain drain, what would you say to the thousands of young Greeks - most of whom are well-qualified or professionals - who have either gone abroad to find a better future or are looking to leave the country? Why should they stay here and if they go, do you think they will return and when?**

I would advise them to leave the country if they can get a job abroad, and not return until competitiveness and macro stability in Greece have been restored. bf