The debt crisis

An insider's view on the Greek situation

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- The Greek debt crisis is everything but resolved, and the concern of the financial markets is increasing constantly. For many, the question is no longer if there will be a restructuring, but rather when.
- Professor Yanis Varoufakis is one of the leading Greek experts on the economic and financial situation of the country. The former adviser to Prime Minister Papandreou has a plan for how to resolve not only the Greek debt crisis, but the euro crisis altogether.
- WMR interviewed Professor Yanis Varoufakis of the University of Athens to learn more about his ideas. We publish the interview in full so investors can get a picture of Mr. Varoufakis' proposal and also an insight into how the crisis affects day-to-day life in Greece. We point out that the opinions expressed by Professor Varoufakis are solely his own and do not correspond to the position of UBS.

Photo Source: Yanis Varoufakis

Professor Yanis Varoufakis is *Director* of the *Division of Political Economy at the Department of Economic Sciences* in the *Faculty of Law, Politics and Economics of the University of Athens.*

Speculation continues about whether Greece will default, while the Greek government and the EU still try to resolve the debt crisis through saving measures and new loans. Yanis Varoufakis, economic and political science professor at the University of Athens, has a radical suggestion to resolve the problem once and for all.

Yanis Varoufakis, as a Professor at the University of Athens, you are a government employee. What changed for you since the outbreak of the debt crisis about a year ago?
My salary has declined by 28 percent. Besides this I feel that the University is completely bankrupt. The University fails to pay assistant professors and my assistants, who are doing a doctorate or post-doc studies. This has a big impact on the quality of our work, even though they are very enthusiastic and they want to work.

Have all Greek employees experienced similar salary cuts?
The salaries of all the public service employees have certainly been cut in a similar proportion. For most contract workers the situation is much worse because they lost their jobs. Looking at the private sector we see that unemployment has more than doubled within a year since the eruption of the debt crisis.

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How is this situation reflected in daily life?
Every single day you pass shops which have only very recently closed down. Then I pass by a soup kitchen of a Protestant church. Before the crisis there were two groups of people going there: the drug addicts and refugees on their way to Western Europe. Within eight months the number of Greeks using it has increased tremendously. Now you have people who not long ago had a job and an apartment or even a house. I know it because I occasionally talk to them. Once you lose your job and you are not eligible for unemployment benefits anymore, life gets difficult very quickly. Soon you can lose your apartment as well, and if you do not have a permanent address, you stand little chance of finding another job, receiving benefits or entering some retraining program. It gets very hard to make a comeback into organized society.

The unemployment rate reached 16.2% in March — a record. 811,000 Greeks are unemployed, 40% more than a year ago. How likely is a popular uprising or revolt if the austerity measures increase?
I think we are already seeing signs of this. Every evening one hundred thousand gather at the Constitution Square in front of Parliament to demonstrate. They behave peacefully, but they are very passionate and united in their opposition to the government in particular and to the political system in general. They oppose the way the government and Europe, not to mention the IMF, is dealing with the crisis. I spoke to MPs and it is very clear to me that they are in complete disarray – the members of the governing socialist party in particular are at a loss on how to resolve the crisis. One MP described her options as follows: "I have the impression the government gave me a gun, so that I can either shoot myself or give it back to them, so that they can shoot me." Greek society is edging very quickly towards a situation of ungovernability.

This does not sound optimistic at all?
No, but every crisis is also a laboratory of the future. We do not know what will come out of it. Crises in the past have sometimes given rise to a better society. On other occasions, like in the 1930s in Europe, the crisis led to the domination of society's worst side: the rise of xenophobia, racism, fascism and a form of populism that creates circumstances of wholesale regression.

What next decisive step will determine the direction of change?
The prime minister is pushing the fiscal adjustment program, as he calls it, through parliament, with budget cuts of EUR 78bn. With this he hopes he can negotiate a new loan in Brussels in the range of EUR 40-90bn. On his triumphant return to Athens, he will address the Greek people saying, "I bought the nation an extension of at least one year's worth, without which the state would be insolvent and unable to pay salaries and pensions." Then he hopes that the heat of the summer, which is considerable in Athens, will see to it that the demonstrations wither as the demonstrators leave the square for the beaches. This will reduce the pressure he is under till autumn.

The plan is to privatize government assets and to buy back debt…
Yes, but in my estimation this will be insignificant vis-a-vis the debt-to-GDP ratio and its explosive path. Greece is in a meltdown. Just look at its share market, its real estate market or any other market. So it is not a very good idea to try to sell off the few remaining assets the Greek state has in a falling – and indeed failing – market. The revenues from this fire sale will be low. The strategy to buy back debt with these lowly revenues is highly questionable in view of the realistic prospect of a future haircut.

You suggest that the ECB should buy EUR 133bn, which corresponds to 40% of the Greek debt, and issue its own Eurobond at much lower interest rates. Do you believe this would resolve the problem?
Yes I do. But, and let me be clear on this, the proposal you are referring to is not merely a proposal for resolving the Greek crisis. It is, rather, a proposal for ending the euro system's crisis and, indeed, for redesigning the euro's architecture. I strongly believe this is the only alternative to avoid the breakdown of the euro. The way Greece is going, along with the rest of the periphery, the whole euro system will collapse with it. I see no end of this domino effect in sight. The Greek situation will worsen, the loans Greece will get will be wasted on repayments that resemble a Sisyphean task: in short, the debt-to-GDP ratio will keep rising. At some point Germany will cease financing the Greek state. Then the imminent default will push Greek banks into bankruptcy. In turn this will lead to a whole cascade throughout Europe. Eurozone banks will begin to feel the strain, the spreads of Spanish sovereign bonds will exceed 9% or even 10% and Spain will prove, as they say, too big to save. Germany will not pick up the huge bill to save, singlehandedly, the whole euro system and will rather choose to bail itself out by reconstructing its own currency. This is my prediction, assuming that Europe continues to walk on the present path.

What is the alternative?
We have three crises going on at once. We have the banking sector crisis, we have the sovereign debt crisis and a crisis of severe underinvestment in the majority of the Eurozone countries. We need to address these three issues at once. Because trying to resolve one leads to the worsening of the situation in one of the other two realms. It is a little like fighting the mythical Hydra: Unless you cut off all its heads at once, attacking them instead one at a time, they will grow back more menacing than before.

How do you want to do that?
Starting with the banks – to strengthen the banks they have to be recapitalized, something that existing shareholders of course reject and struggle against. For this reason, they must be forced to accept recapitalization so that they stop operating totally dependent on the ECB for their liquidity. This recapitalization could be done by the European Financial Stability Fund (EFSF), which will take shares from these banks in exchange. Instead of throwing good money after bad by lending to Greece, Portugal and others, the EFSF should use its funds to recapitalize the banks, cleanse them in a short space of time and, soon after sell the shares it holds, even at a profit. This would energize the banks, strengthen the financial system and cost the European taxpayer absolutely nothing.

What would happen to the debt, under your proposal, if the EFSF deals with the banks, as opposed to the debt problem that it was set up to address?
The debt crisis cannot be dealt with by means of loans, from the EFSF or from anyone else. Insolvency problems cannot be solved by pouring (expensive) liquidity on them. The debt of the member countries should be divided into the Maastricht-compliant part, which is up to 60% of GDP, and the rest, which is above this limit. The first part, which is Maastricht-compliant, should be then transferred to the ECB.

What does this mean?
The ECB does not buy the bonds of the member states but, instead, takes these bonds on its books and undertakes to service them on condition that the member states repay the ECB to the full in the long run. For that purpose, the ECB opens a debit account for each participating member state – our idea is that participation in this debt-transfer or debt-conver-

sion scheme is purely voluntary and open to all member states, Germany included.

And how does the ECB service the member state bonds that have been transferred to it?

Not by printing money, but rather by issuing Eurobonds guaranteed by the ECB itself, as opposed to by the triple-A member states which are then floated in the international money markets. The ECB, with its solid reputation, would be able to borrow at no more than 3%. In turn, the member states will begin repaying their debt to the ECB over a period equal to the maturity of the ECB Eurobonds and at an interest rate just above that of the ECB's Eurobonds. Thus the aggregate European debt will deflate. Immediately the spreads within Europe will shrink considerably. Even the basket case Greece will be able to roll over its remaining bonds at no more than 6% compared to the 15+% the markets now demand. The debt crisis would be over.

Also for Greece?

Actually Greece would still have a problem, because Greece has a debt equaling 155% of GDP. Greece needs additional medicine. Most of the Greek debt is in the hands of Greek banks, which are effectively bankrupt. They will have to be heavily recapitalized through the EFSF and supported further by the ECB's liquidity. Here is how this could happen: When Greek bonds held by Greek banks and now transferred onto the ECB's books mature, the Greek banks will go to the ECB to cash them in. At that point, the ECB can say to them: Unlike other bondholders, you are being kept alive by our extraordinary liquidity provisions. To continue the latter, you must adhere to the following two conditions. First, you must accept more capital from the EFSF in exchange for another swathe of your shares and, secondly, you will swap the Greek bonds you have for new ones worth a fraction of the older ones' value and with longer maturity. So this will be a haircut, but a very selective haircut for formerly bankrupt banks. Note that the credit rating agencies cannot see this as a credit event, because in effect it constitutes no more than a concession by a bankrupt firm so that it can be bailed out.

What is the third point?

The dearth of investment throughout much of the Eurozone. Europe and especially the periphery need more investment to be competitive with other regions and continents. This is where the European Investment Bank (EIB) can come in and play a decisive role. Compared to the World Bank, the EIB has double the capacity to finance investment projects. The major problem, which stops the EIB from aiding Europe to get out of this crisis, is the stipulation on its charter that 50% of every investment project must be financed by the member country where funds will be invested. However, the member states in the periphery can not finance anything right now. This problem could be solved by putting to good use the debit account that each member state will by now have with the ECB.

How?

The ECB would co-finance these projects through additional issues of Eurobonds and charge them to the debit account of the country in which the project is to be realized. This small change would unleash the investment powers of the EIB and energize the European economy.

Why has your idea not been realized by now?
Three reasons: The first I refer to as institutional inertia or conservatism. Many colleagues and politicians protest that the Central Bank cannot play the role we suggest it does. That it is not its business to issue bonds and partake of fiscal policy. That this is the job of some pan-European Treasury. My reaction to this objection is that the ECB is a unique central bank in that it has no counterpart in some Federal European Treasury. This, in fact, is a major cause of the current euro crisis. There are two things Europe can do in response: One is to create the missing union treasury with powers to tax, borrow and spend. Alas, there is no way that Europeans will agree to this within a decade, and in any case, such a development requires a radical change in Europe's treaties and institutions (a political and logistical nightmare). But there is another way: the one we are suggesting. The ECB's exceptionalism (the lack of a Treasury counterpart) can be addressed by means of the small innovation we are suggesting – allowing the ECB to issue Eurobonds and so forth. The fact that no other central bank does this is neither here nor there. Europe embarked on a unique course when it decided to bind its economies monetarily, but not fiscally. It must now innovate again, doing something that has never been tried before to save the currency union it created only a decade ago.

What is the second reason?
The second reason is what I call coordination failure: When I speak to politicians outside of Greece they all tell me the same thing. If the finance minister of Spain or of Italy would openly support this idea, the spreads of this particular country would go through the roof, because the money markets would consider this statement a sign of weakness. Similarly with bankers: If a banker comes out openly in favor of this plan, the shares of this bank will go through the floor, because the financial market will assume that the bank is facing difficulties. This is what we call a typical coordination failure: All would be better off if a common decision could be coordinated and announced at once yet no one dares to propose it individually. It is a clear case of the lack of political leadership and coordination at the center of Europe. The third reason is the political value of the surplus countries' exit option: Presently, the German Chancellor enjoys a fantastic degree of authority within the European Council courtesy of the fact that everyone knows that the surplus countries (Germany, Austria, Finland and the Netherlands) are the only ones that can get out of the euro if they wish, despite the hefty costs that such an exit would bring to them. This exit option boosts Ms. Merkel's bargaining power, and her power to set Europe's agenda, to no end. By agreeing with our proposals, e.g., the creation of common debt via the issue of Eurobonds, Germany in essence gives up its exit option, and thus its extraordinary political privilege. It is understandable that the surplus countries are reluctant to adopt this proposal. In contrast, Greece and the other debt-stricken countries cannot exit the euro, because announcing that they want to get out would lead to a massive outflow of capital. And if Greece would try to get out, Ireland would have to introduce capital controls, a measure which is not compliant with a monetary union. The situation would be different, however, if Germany announced it intended to get out. Then there would be a capital inflow. So this situation increases Germany's influence and power within the EU. If our plan were accepted, Germany would lose this exit option because once you have common debt, which would be the case when the ECB issues Eurobonds, you cannot assign a particular portion of the debt to a single euro member state. This is the same reason why California could never leave the 'dollar zone.'

But it should be possible to overcome this failure?
Yes. When the euro reaches a critical stage, and Europe must choose between something like our proposals and disintegration, I trust and hope that the current impasse will be overcome. But even then, the only way to

implement proposals like the ones presented here would be to announce this plan in a coordinated way by the EU, the ECB and the major European banks. Then the spreads would go down instantly and all shares would rise. Unfortunately Europe is cacophonous. In the United States, President Obama, Fed Chairman Bernanke and Secretary of the Treasury Geithner get together on a Sunday afternoon and announce their plan a few hours later before the markets open in Asia. This is not possible in Europe.

Getting back to the situation as it is now. Do you think that a default will be avoided?
There is no way a default can be avoided. My models – simulations based on macroeconometric models that are in turn based on reasonable and uncontroversial assumptions – show that in the best of all cases, i.e., even if the recession ends this year and then growth of 1% is established next year and then 1.5% from then on; even if the privatization program yields EUR 15bn this year, EUR 15bn next year and EUR 10bn in 2013 and again EUR 10bn in 2014; even if all public spending is curtailed according to plan – which is, in truth, a science fiction scenario, the debt-to-GDP ratio will begin to rise fast after 2017, eventually topping 200%. So, unless some comprehensive solution is applied – and we have proposed one such solution – Greece will have to default, with all this means for the rest of the euro system.

What will be the most likely outcome?
It is very hard to say, because one has to predict how politicians will decide. I believe they will try to buy time, muddle through, and in about one year there will be a major haircut of Greek, Irish and Portuguese debt. Whether this strategy will avert a cascade of failures that leads to the euro system's disintegration is a matter of private judgment. My expectation is that Europe will be forced to change tack if it wants to salvage the euro project.

Appendix

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