Michael Haliassos

The Fiscal Crisis as a Crisis in Trust

Policy Letter No. 25

SAFE | Sustainable Architecture for Finance in Europe
A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Grüneburgplatz 1 | 60323 Frankfurt am Main

Tel. +49 69 798 33684 | Fax +49 69 798 33910
policy_center@safe.uni-frankfurt.de | www.safe-frankfurt.de

The Fiscal Crisis as a Crisis in Trust

Michael Haliassos

May 2014

The sources of the fiscal crisis have been different, but the prescribed measures amount to two: achieve budget surpluses to start reducing the size of the debt, and undertake the necessary reforms to create or boost the productive base, so as to make repayment of the debt possible and compatible with acceptable living standards. If we manage to hit only the first bird, the other may well fly away.

"Owning" an adjustment program is a hopeless prospect when practically all its measures are widely perceived as negative. On the fiscal front, Greece had cuts in government expenditures (including investment, education, and social programs), massive layoffs, cuts in salaries, wages, and pensions, increases in tax rates (such as VAT), and a creation of new taxes (such as those on real estate). On the reform side, Greece found itself trying to liberalize professions that are not in short supply, and trying to explain to people why making it easier to lay workers off in the midst of higher unemployment rates than in the Great Depression is actually good for employment.

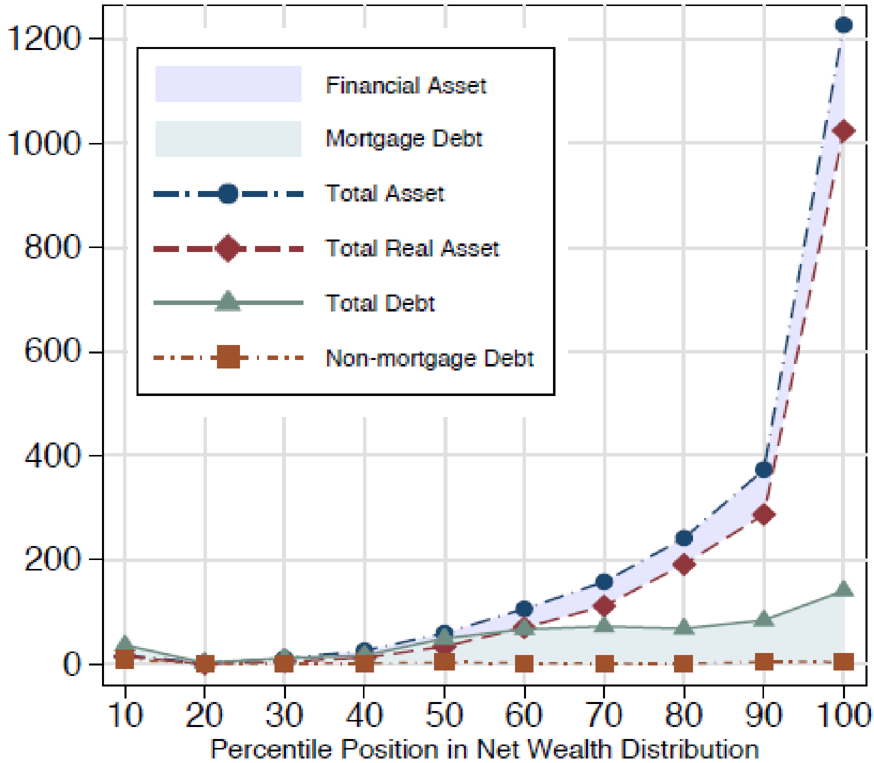
Dismal macroeconomic performance, even in the face of a primary budget surplus, creates a vicious cycle of mistrust. Northern public opinion, if not always that of politicians, does not trust the South because it views the continuing poor growth performance as a failure of the South to reform itself and to produce. Southern public opinion does not trust the North, because it views the recession as the creation of Northern insistence on budget and salary cuts and on reforms that threaten job security. We need to break out of this vicious cycle of mistrust, macroeconomic underperformance, and social unrest, and refocus our efforts on creating a strong productive base, on debt repayment potential, and on conditions for investment-led, export-oriented, sustainable growth.

In the fiscally troubled southern countries, the time since the start of the fiscal crisis can be described as one of a three-pronged assault on household liquidity. First, households experienced lower wages, salaries, and pensions. Second, they faced much greater unemployment risk and longer unemployment spells. The third prong took the form of taxes on illiquid real estate, often marketed as taxes on the rich. Faced with this assault, households had to dip into their limited liquid asset buffer, and many were driven to financial distress.

Tax increases and wage cuts

The Household Finances and Consumption Survey (HFCS), the recently available data on Eurozone household finances, shows that the liquid buffer in Germany was much larger than in the South at the start of the crisis. While in Germany real estate holdings become important only in the upper half of the distribution of net wealth, in the South they are relevant virtually throughout the net wealth distribution (see Figures 1a and 1b).

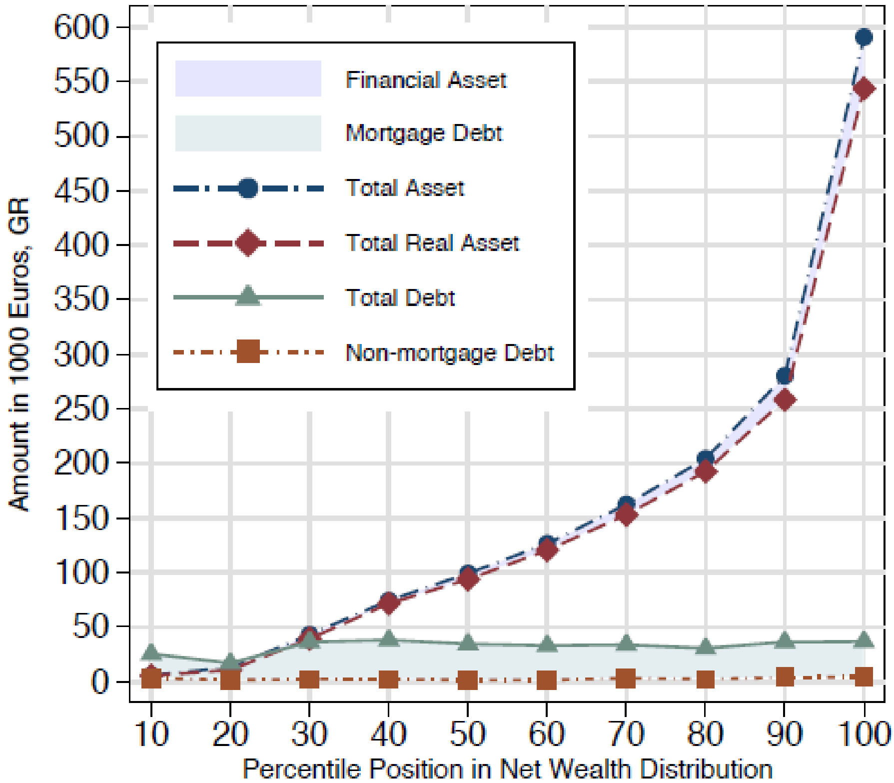
Figure 1a: Composition of Household Net Wealth at the Start of the Crisis – Germany



Source: ECB
Household Finance and Consumption Survey, 1st Wave

This means that real estate taxes are not paid only by the rich, and that we are requiring payment of such taxes from many households who neither had nor are now able to acquire the liquid resources to meet such tax obligations. This has contributed to the steeply growing share of non-performing loans in the banking sector, which rose in Greece from about 8% in 2010 to about 33% in 2014.

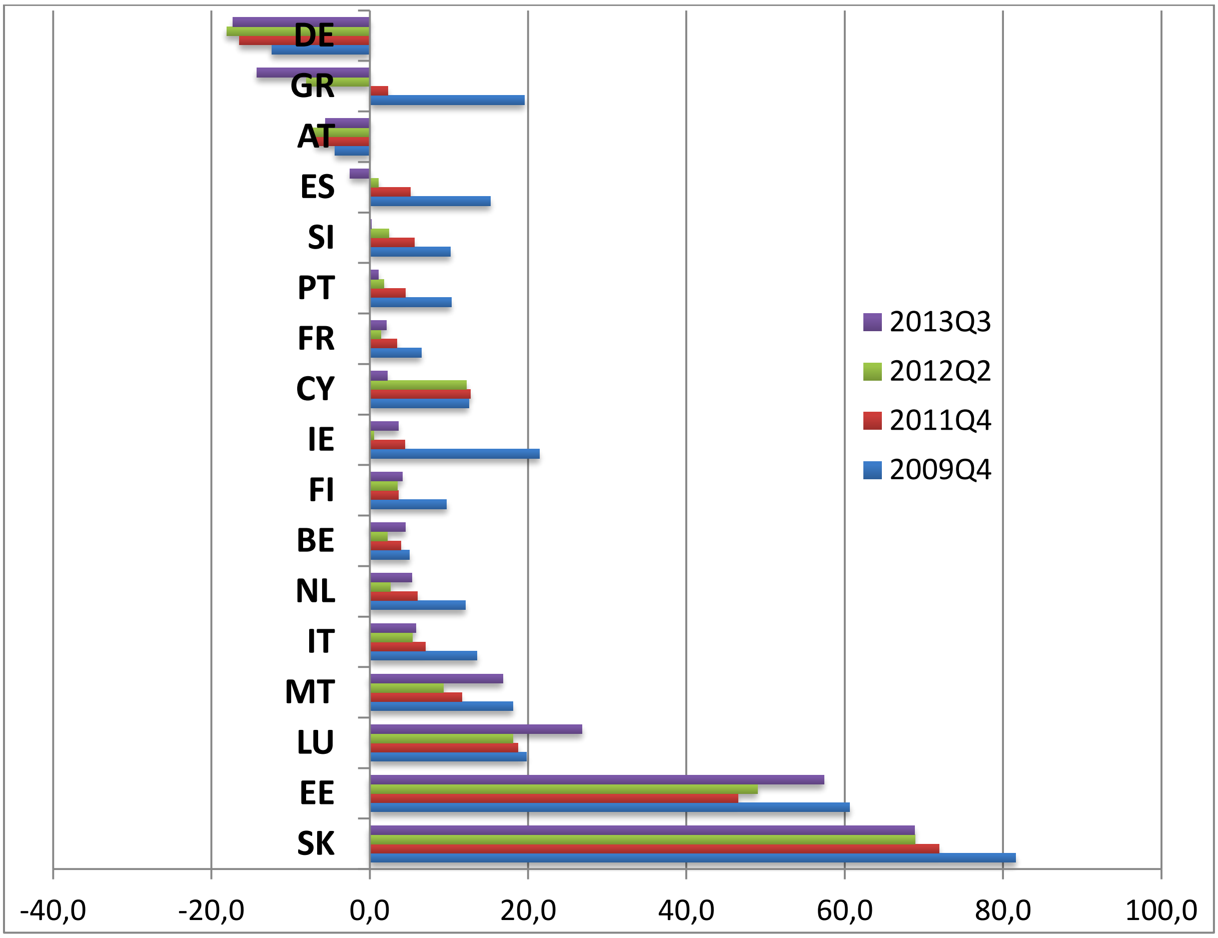
Figure 1b: Composition of Household Net Wealth at the Start of the Crisis – Greece



Source: ECB
Household Finance and Consumption Survey, 1st Wave

What was the effect of lowering wages and salaries? The ECB constructs a harmonized competitiveness index based on unit labor costs, which takes into account how these change compared to other Eurozone countries and their major trading partners. By the start of the fiscal crisis in 2009, all Eurozone countries except for Germany and Austria had experienced deterioration in labor cost competitiveness relative to 1999, but Ireland and Greece were at the top of the now fiscally challenged countries (Figure 2). Following the start of the fiscal crisis in 2009, the wage and salary cuts in Greece were so massive, that already by the second quarter of 2012, Greece was a Eurozone champion, with an improvement in competitiveness second only to Germany. Wage and salary cuts proceeded further, producing even larger improvements by the third quarter of 2013, with Spain also joining the team of champions.

Figure 2: Lowering Wages: Did it boost competitiveness? Change in ECB Harmonized Competitive Index since 1999Q1.



Source: ECB Statistical Data Warehouse. Eurozone Countries, based on Unit Labor Costs in 2009Q4, 2011Q4, 2012Q2 and 2013Q3. The index measures the price and cost competitiveness vis-a-vis intra- and extra-euro area trading partners. A positive change points to a decrease in price competitiveness, a negative change to an increase in price competitiveness.

Evolution of Greek Exports

Yet, there is a sobering lesson to be learnt. Despite this impressive increase in unit labor cost competitiveness, neither investment nor Greek exports have taken off.

Figure 3a: Exports of goods (volumes; 2008 = 100)

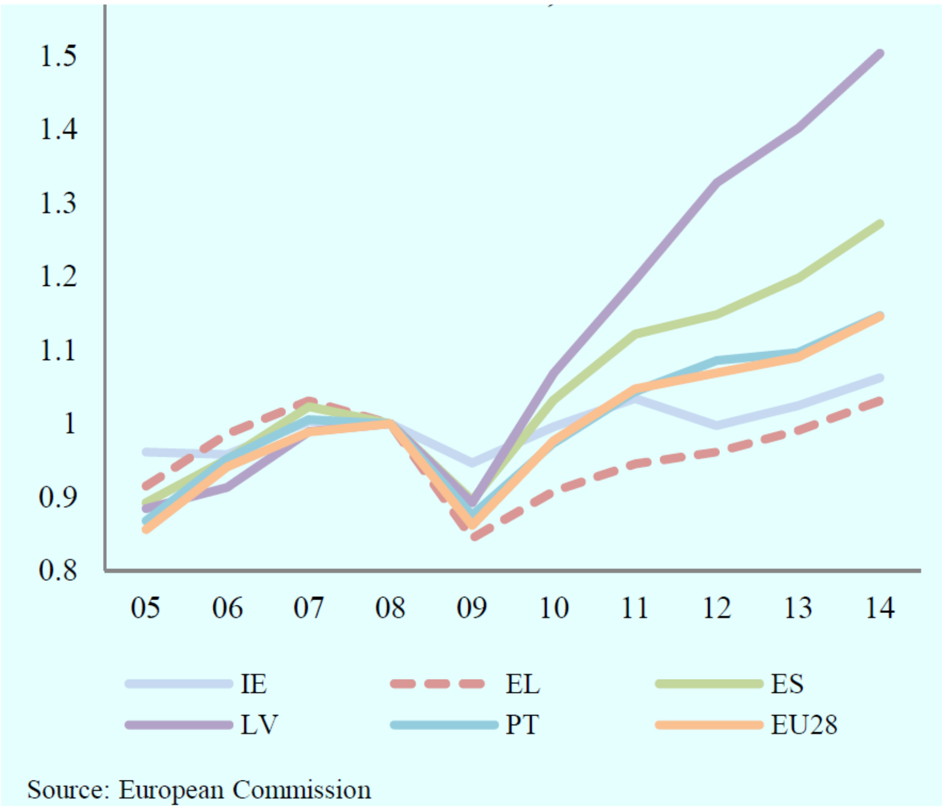
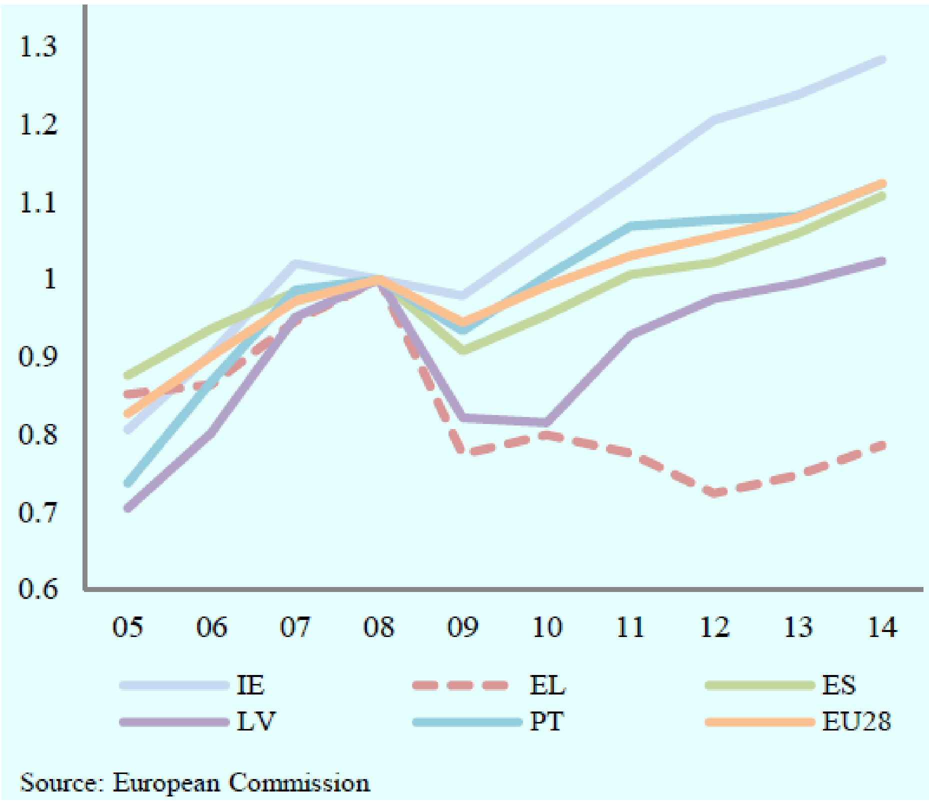


Figure 3b: Exports of services (volumes; 2008 = 100)



Source: European Commission, The Second Economic Adjustment Programme for Greece, Fourth Review – April 2014, p. 15. EL = Greece; IE = Ireland; ES = Spain; PT = Portugal; LV = Latvia.

Net exports improved primarily due to the drop in imports arising from lower incomes: exports of goods and services hardly took off and are expected to be stable, with exports of travel services fluctuating in response to the negative political climate in Turkey and Egypt. In terms of export volumes, Greece has been the slowest among adjustment countries to catch up to its pre-crisis volume of exports of goods and is not clearly converging in the exports of services (see Figures 3a and 3b).

The vicious cycle of mistrust

Here comes the vicious cycle of mistrust. Neither Northerners are willing to invest in a South they perceive as hopeless, nor are Southerners willing to invest in their countries in a climate of austerity, policy uncertainty and even ambiguity imposed by the North.

Hans Werner Sinn exemplifies northern attitudes regarding the real side of the economy. He points to the same facts: a drop in unit labor costs and a lack of investment and export growth. He infers from these that even greater cuts in unit labor costs are needed. As it is politically infeasible to cut wages and salaries further, he advocates a (temporary?) exit from the Euro, certainly for Greece and possibly for some other Southern countries. Here is an analogy: the medicine did not work, so we need more of it. Because the patient cannot tolerate a higher dose, it is best to take him off medication and leave him on his own. Medical doctors follow this approach for terminally ill patients.

The northern position on the financial side exhibits remarkable consistency. At the start of the fiscal crisis, Germany did not want to be part of any rescue package, preferring to leave this to the IMF. After the Northerners got involved, they promoted Policy Support Instruments (PSI) based on the notion of moral hazard. Moral hazard, in this case, means simply that, if you rescue southern governments or banks that cannot meet their obligations, they will get in trouble again. So, PSI measures made sure that banks that invested in southern government bonds participated in the losses; and progressively, as in Cyprus, that even depositors of troubled Southern banks paid part of the cost of keeping the banks alive. Moral hazard dominates thinking if you do not trust your partners to behave and your instruments to control them. Notice that almost no effort has been devoted to designing financial instruments that could help manage the risks of investment in the uncertain southern economic environment. The trust for such investment is not there.

Southerners doubt that Northerners care about anything else except for short-run fiscal improvement. The political dialog in the South got completely disoriented. Instead of debating what is the most promising set of reforms to build productive potential and guarantee longer-term living standards, political parties debate on whether the Northerners should be involved at all in the management of the crisis (through the Memorandum) or whether the South should completely opt out of the Eurozone to avoid such interference and monitoring.

Cutting the Gordian Knot

How can the South cut the Gordian knot and propel itself to sustainable growth? In a nutshell, the South should focus on creating a dynamic, innovative, export-oriented productive base. It is imperative to promote entrepreneurship, research leading to innovation, and a lean public sector that fosters rather than hampers entrepreneurial initiatives.

Instead of cutting wages and salaries horizontally, so that the best people leave the country, the South should be ready to pay good salaries for high productivity and quality. German workers compete with the Chinese, but they are not being told that they should get Chinese wages. They are told instead that they can earn more if they deliver quality (the “Made in Germany” label). This is an inspiring rather than a demoralizing message.

In Greek universities and research centers, there are true pockets of excellence, despite the limited funds and the poor organization of the system. At the same time, there is enormous human capital, spread all over top universities and research centers abroad. This is a pitiful equilibrium. The problem needs to be solved for various reasons but also for boosting the creation of a productive base: the quality of human capital is important for decisions to invest in the country, and the quality of research is important for innovation. Since the State cannot afford to build attractive university structures with enticing academic salaries and ample funds for research, it should become possible for non-profit private universities to be established, albeit under strict standards and continual accreditation procedures. This can create even an additional major source of export revenue for Greece directly (as has been the case for the UK).

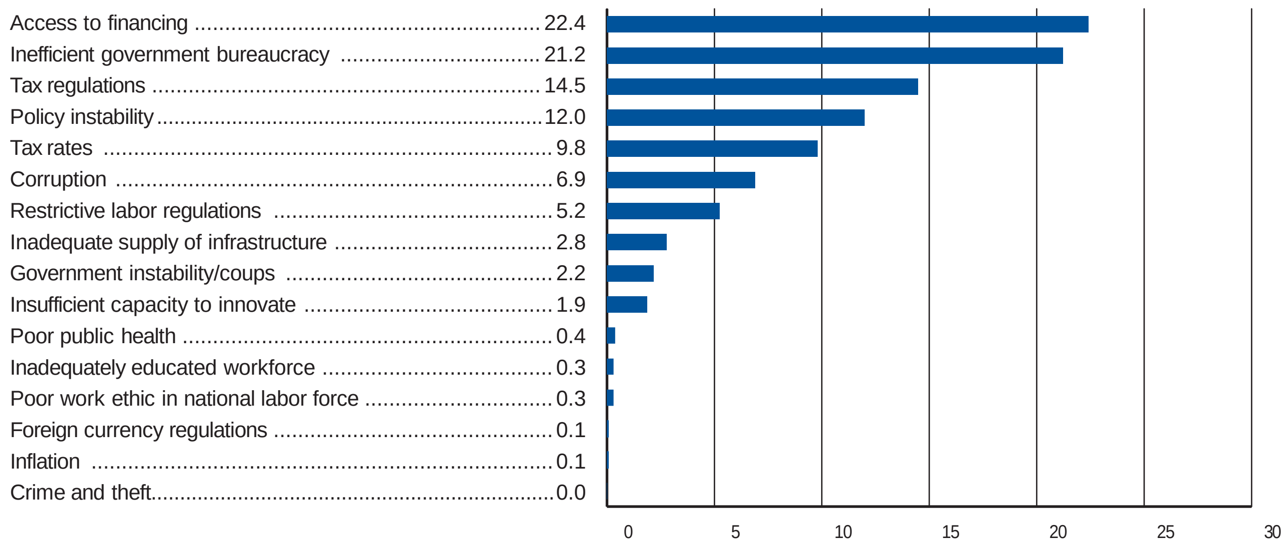
Finally, the experience of Troika negotiations in fiscally troubled countries has shown that, despite good intentions, there is a lot to be gained by mobilizing native research talent familiar with the peculiarities of the country in crisis and with the levers that need to be pulled to get it out of the crisis. It takes a program to beat a program. My understanding is that, in Ireland, there was initial acceptance of the adjustment conditions, but Irish researchers wasted no time to devise equivalent measures much less costly to the Irish population, and those were adopted as relaxations of the Memorandum. Independent, research-based policy advice requires high-quality, outward-oriented, internationally connected, and flexibly structured research centers for economic and social policy design and evaluation. These should be established now.

Many Northerners claim that reforms will not succeed, especially in changing financial behavior, because of poor 'southern culture'. In a recent working paper with Jansson and Karabulut, we used different criteria, ranging from genetic distance to responses on culture-related questions, to divide Europe into culture groups. We were surprised by the robustness of the classification that emerges, but even more so by the result: it is the Northerners who are culturally similar between them, not the Southerners! Although there are cultural differences in financial behavior, with longer exposure to common institutions, financial behavior tends to converge. Our findings support the view that institutional harmonization, as the one attempted in Europe, can contribute to convergence in behavior across people with different cultural predispositions.

Obstacles for entrepreneurship and innovation in the South

Let me end by focusing on what creates obstacles for entrepreneurship and innovation in the South. The Global Competitiveness Report (2013-14) asked 13,000 business leaders in 148 countries to name the most problematic factors for doing business. In Greece (see Figure 4), the top factors were access to financing, inefficient government bureaucracy, tax regulations, and policy instability. Notice that high wage costs or poor work ethic were not considered important.

Figure 4: The most problematic factors for doing business: The Greek Perspective



Source: The Global Competitiveness Report 2013-14, p. 198.

Note: From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

What about the Northerners? In April 2014, the Center for Financial Studies surveyed key people in the financial industry about factors they would consider as key for investing in the Southern crisis countries (Table 1). The absolute majority of these key Northerners considered having to pay low wage levels “less important”. The factors they considered as highly important were a good educational system and high human capital, as well as legal security. It is striking how similar are the concerns of Southern and Northern investors and entrepreneurs, and how limited attention they have received in the implementation of adjustment programs to date, compared to massive horizontal salary cuts.

The Ease of Doing Business index of the World Bank illustrates a further point: the wide available margins of improvement, and how long it takes to take advantage of them. Between 2013 and 2014, Greece’s ranking in the category “ease of starting a business” improved by 111 positions, from 147 to 36, illustrating what is possible. This example, however, also shows that the change took 5 years to implement, demonstrating the rigidities of the system. Implementing change should be made much easier.

Table 1: Investment barriers in crisis countries as perceived by German Financial Industry

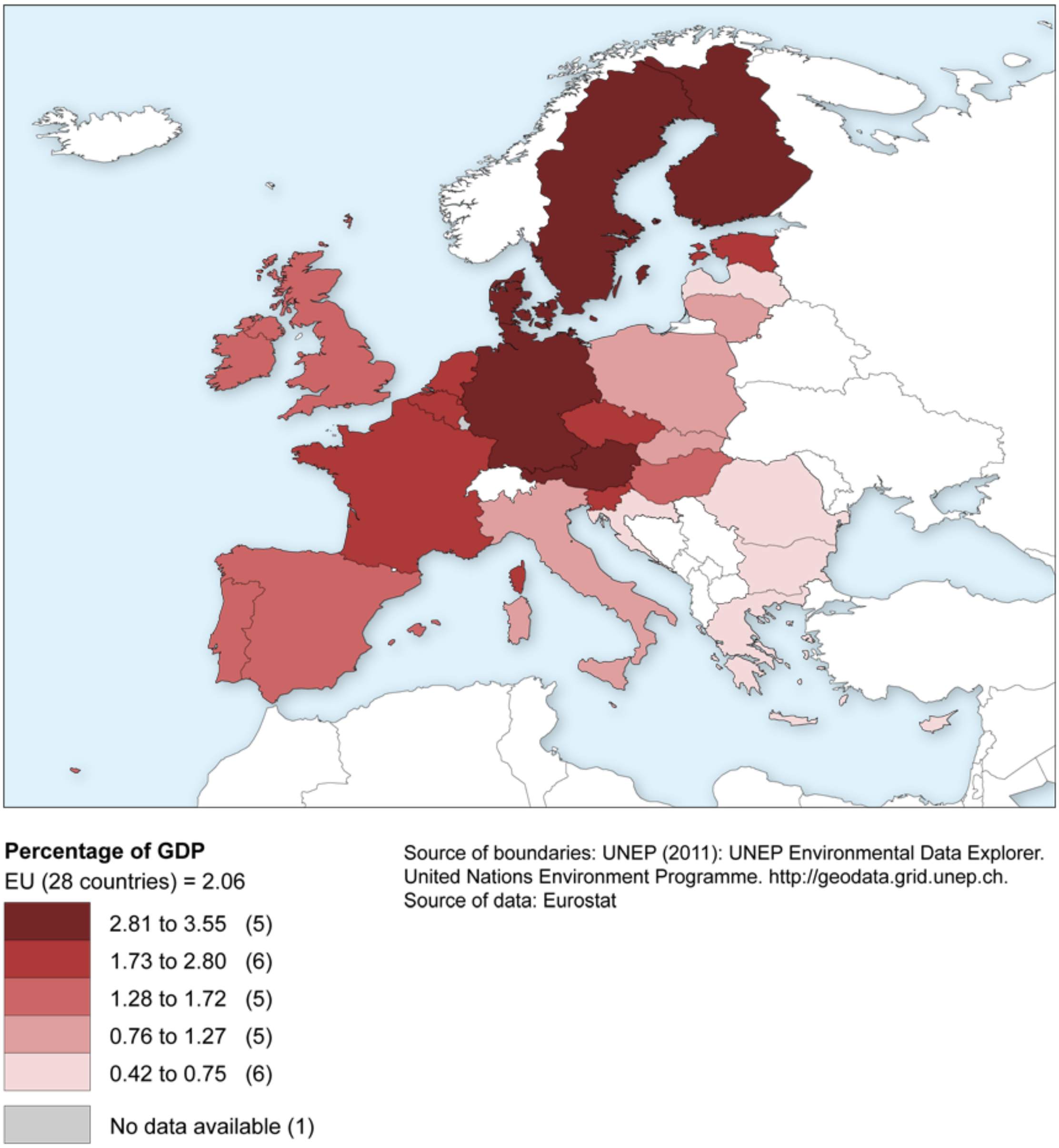
Answers	Percentage of people who favored the following answers			
	Very important	Important	Less important	Not important
Soundness of Public Finances	28,8 %	53,5 %	15,6 %	2,1 %
Attractive Tax System	20,7 %	57,5 %	19,6 %	2,2 %
Low wage level	9,4 %	27,1 %	**56,2 %**	7,3 %
Good educational system / Human capital	62,3 %	33,5 %	2,6 %	1,6 %
Legal security	89,8 %	9,7 %	-	0,5 %
Good infrastructure	29,2 %	59,8 %	8,3 %	2,7 %
Flexible Labor Market Structure (e.g. low power of labor unions, little dismissal protection, etc.)	14,2 %	50,9 %	30,1 %	4,8 %
Differential regulation / Bureaucracy	28,6 %	52,7 %	16 %	2,7 %

Source: CFS Index Survey, April 2014. Question: How important are the following factors in case that a company in your industry, based in Germany, would consider an investment in any of the southern European countries that are in crisis?

Transparency International surveyed a large number of people regarding their perceptions about the level of corruption in each country. Among the fiscally troubled countries, Ireland and Portugal fare best, while Greece finds itself in position 80 among 177 countries in 2013, just above Swaziland and Burkina Faso. Such perceptions need to be eradicated if foreign or domestic investors are to be attracted. Foreign investors declared legal security and investor protection as highly important. According to the EDB 2014 report, Greece fell in the ranking of enforcing contracts to 98th place in 2014. It now takes on average 1300 days to enforce contracts, compared to 529 days in the OECD. This is moving in the wrong direction. In terms of competitiveness, where business sophistication and innovation are important, the Global Competitiveness Report of 2013-14 puts Spain in the 35th place, Italy at 49, Portugal at 51, and Greece at 91, between Namibia and Trinidad and Tobago. The South can only benefit from improving such widespread poor impressions of business leaders.

The share of GDP contributed by the private and public sector to Research and Development is highly important for innovation. Greece and Italy find themselves in the lowest category in the European Union (Figure 5). By boosting such spending from about 0.7% to 1.5%, they can join Spain and Portugal at a much higher position.

Figure 5: Gross Expenditure on R&D Relative to GDP 2012



ESET, the National Council on Research and Technology in Greece, whose three-year term ended in December 2013, polled top researchers about pockets of research excellence, critical research mass, and technologically and economically promising projects for the period 2014-2020. It has proposed a plan for areas to be funded and for how the level of funding can be gradually expanded to attain 1.5% of GDP.

The analogy of the half-empty versus half-full bottle is well known. These statistics are not here to discourage but to indicate what is possible to aim for in the South generally and in Greece more specifically. Taking concrete, big steps in the direction of reforms, and utilizing the positive climate recently generated by the achievements on the deficit and bank recapitalization front may provide just enough thrust to break out of the vicious cycle of mistrust, propel Greece to a much happier future, and promote the chances for more balanced economic performance in North and South.