MEMORANDUM
To: Mario Draghi, President of the European Central Bank
From: Stephanie Apollon
Re: Addressing Debt Management in Greece

Summary

After the revelation of the budget deficit faced by Greece, the European Union (EU) has been challenged with helping Greece in order to avoid the possibility of Greece defaulting on its loans. The crisis has revealed that Greece has a weak accounting system and a disjointed public administration that has not been transparent about the country's finances. Along with this, Greece does not have an efficient budgeting system to keep track of spending. However, Greece has had to reveal its shortcomings due to the global financial crisis, putting responsibility on members of the EU to consistently bail Greece out of its financial obligations to the International Monetary Fund (IMF). In order to remedy the amount of debt owed by Greece, the following recommendations will be made. The EU should completely bail Greece out of its debt with the IMF under strict conditions or the EU should be allowed to default in order to claim bankruptcy. If Greece can claim bankruptcy, payments and accruing interest would freeze and Greece would have a chance to strengthen its public administration and policies.

Issue Description

Towards the end of 2009, a spotlight was put on Greece when Greece announced the reality of its budget deficit. However, it can be said that the crisis got its start when the country's budget deficit increased from less than 3% in 1981 to 11% in 1991. [1] By 2001, the Greek budget deficit went from 11% to 6% as the country joined the Economic and Monetary Union (EMU) of the EU.[1 2] Joining the EMU meant that Greece went from circulating the drachma, currency formerly used in Greece, to the euro.[3] With the adoption of the euro, capital markets and investors had confidence in the Greek economy, which gave Greece access to cheap capital.[4] This meant that Greece was able borrow money from the market to support its economy.

Despite the economic upswing Greece experienced due to the perceived credibility of its economic policies, Greece soon faltered as a result of the global financial crisis of 2007 to 2008. Due to the collapse of the housing bubble in the United States, all European countries were affected due to the interconnectedness of the global markets. This global financial crisis was the biggest case of financial instability since the Great Depression. Although the global financial crisis did not cause the Greek financial crisis, the global financial crisis pushed Greece to reveal its economic truth.[5]

As financial markets faltered, Greece announced in October 2009 that they "had been understating the amount of [their] deficit figures for years." This caused the financial markets to shut Greece completely out from borrowing within the markets. The total amount of Greek debt was reported as being 126% of its GDP and investors were not in a position to take risks after accepting huge financial losses. Concurrently, a new administration entered Greece and revised the estimated debt of 6.7% to 12.7% of the GDP.[4] As a result, in 2010 economic growth shrunk to 2.5%. Economic growth lowered even further to 0.7% in 2011 and unemployment reached 12.6%.[2]

In response to the Greek debt crisis, the EU, the European Central Bank, and the IMF gave Greece a financial assistance package.[4] When the IMF offers assistance to a country, loan conditionalities come into play. This means that there is an agreement on conditions made by the receiving country in order for the IMF to issue a loan, debt relief, or bilateral aid to ensure the stability of a monetary system.[6] The European Central Bank also responded by buying Greek bonds and supporting Greek banks.[4] Yet, even with assistance, Greece continued to spend a high amount on defense, which represented 2.1% of its GDP.[7]

Since the global financial crisis, Greece has been reliant on bailouts. Although Greece has received billions in bailouts between the IMF and the EU, the economy of Greece has shrunk by about a fifth and unemployment is above 25%. Rather than contributing to the Greek economy, the bailout money Greece receives has gone towards paying international loans. Today, Greece has a total debt that accounts for 180% of its GDP. Currently, Greece has been freed from making a debt repayment to the IMF until the summer of 2017. However, members of the EU are not keen on providing any more aid to Greece.[8]

Analysis

How Greece Acquired Debt

Prior to joining the EU, Greece received investment aid from the EU. Once Greece joined the EU and adopted the euro, Greece began to overspend. The euro kept borrowing costs down which made it easy for Greece to secure funds from commercial banks with low interest rates. This, in turn, made Greece increasingly dependent on inexpensive loans. With a dependence on loans, public sector wages in Greece doubled and government spending escalated.[7] Along with borrowing habits, between 2003 and 2010 government expenditures increased by 44.7% but revenues only grew from 39.0% to 39.1% of the GDP. These figures signaled to an existing deficit and hinted at the country's inefficient public administration.[2]

Contributing Institutional Factors to the Debt Crisis in Greece

Many truths were realized after the announcement of the Greek deficit. First, the government lacks resource centralization. Greek ministries have too much operational independence due to its limited cabinet structure. This lack of coordination within the government sectors contributed to inefficient record keeping measures. For example, an official count on the total number of public sector employees did not exist.[9]

Another issue faced by the Greek government are its weak accounting standards; mainly that Greece does not use International Public Sector Accounting Standards. Additionally, Greece lacks a sufficient amount of trained accountants. Without accounting standards and few trained accountants, the Greek government has not done well with bookkeeping. Overall, there is a lack of transparency and accountability.[10]

These issues contributed to the unruly budget management process of the Greek government. After the 2009 Greek deficit announcement, records showed that the government budget of Greece was based on about 14,000 separate "budget lines." Each "line" represented grouped item expenditures within the public administration. This was problematic because the abundance of "lines" obscured public spending making it difficult to trace and analyze past spending. The financial issues Greece faced also came from tax evasion. In 2010, tax evasion losses for the Greek government was estimated to be over $20 billion. In 2013, figures showed that less than

half of the total amount of tax revenues were collected. Without the full amount of taxes owed by the public, the government of Greece was losing about 20 billion euros a year.[2 9] With a significant loss in missing tax revenues, Greece owed the IMF 300 million euros after delaying debt repayment by 2015.[11]

Present Day Fiscal Challenges Faced by Greece

Greece has had to agree on a number of reforms in order to continue receiving funds from bailout assistance. Presently, however, European creditors have refused to continue funding Greece unless the country enacts further policy reforms.[12] In terms of the IMF's involvement, IMF directors are split between what they believe the Greek fiscal surplus target should be; some board directors favor a surplus target of 1.5% of GDP while other favor a 3.5% target surplus. However, despite the IMF's continued involvement in discussions over Greek finances, the IMF has yet to commit to participating in negotiations on a new financial deal starting mid-2018.[13] Finally, with German elections on the horizon, Germany may only offer Greece a minimal amount of financial assistance in order to appease German citizens.[12]

Suggested Solutions

The following are the suggested solutions given by international leaders and commentators involved with the Greek debt crisis:

1. *Allow Greece to default.* - Anthanasios Vamvakidis, head of European currency strategy for Bank of America, suggests that Greece needs to experience the extremities of its situation in order to enact serious policy reform quickly. Another theory suggests that if Greece defaulted, Greece could go through a bankruptcy process that would freeze payments and allow Greece to negotiate with creditors. However, Greece would face challenges borrowing from global markets and would have to build up a strong government with strategic policy reforms.[12 14]

2. *"Grexit," ie: a return to the drachma* - If Greece reinstated the drachma, there would be a potential boost to the Greek economy. Returning to the drachma would have to coincide with expansive public policy improvements to stimulate growth and reduce unemployment. However, returning to the drachma may inhibit Greece from borrowing from European markets Leaving the euro-zone may also delegitimize the euro and the drachma could decline in value.[15 12]

3. *Updating fiscal targets* - Many critics of the IMF bailout plan with Greece believe the IMF has set unrealistic financial targets for Greece to accomplish. Yannis Stournaras, Governor for the Bank of Greece, suggests measure reforms are needed to give Greece a real chance to succeed. In order to accomplish this, Greece would need to raise taxes to collect more revenue. However, in conjunction with tax raises, Greece would also have to strengthen their public administration and recording practices.[16]

Recommendations

After reviewing solution suggestions I believe the following recommendations should be considered. These recommendations are interconnected and multiple recommendation combinations can be considered:

1. The EU should consider completely bailing Greece out of its IMF obligations if the EU has the means. The EU should consider this as an option because nations joined the EU for stability. However if the EU were to consider this option, this solution should have strict implementation conditions. If the EU were to bail Greece out of its obligations to the IMF, this should only be done if Greece agrees to reform its public administration, policies, and accounting measures under strict guidance and surveillance. If Greece fails to follow guidelines, the EU should consider allowing Greece to default.

2. The EU should consider allowing Greece to default. If Greece can claim bankruptcy, this will enable Greece to take full responsibility for the situation. Bankruptcy would prove to be challenging but incurring credit on loans and payments would freeze. This would allow Greece to prioritize payments while strategizing ways to strengthen its public administration, policies, and accounting systems.

3. Whether Greece is aided by the EU or defaults to claim bankruptcy, the Greek government should be working endlessly to improve its public administration. Regardless of what happens in Greece financially, Greece needs to prioritize accounting standards and the reform of its public policies.

4. Greece should consider implementing an accounting incentive program with the help of the International Public Sector Accounting Standards (IPSAS) Board. Having Greek trained accountants will be essential for Greece when it comes to creating budgets and keeping track of spending and revenues. If Greece does not have a strong accounting program at a university, perhaps Greece can consider partnering with universities around the world. Partnering with universities abroad could help gain the interest of Greek citizens. Along with this, Greece should implement IPSAS Standards as part of its policy reform

5. Taxes need to be raised and spending needs to be reduced. Greece has already reduced its spending but continues to struggle collecting revenue. Although public backlash could ensue with a tax raise, there could be a public campaign appealing to citizens in order to explain how a tax raise is in the best interest of the public for the future of Greece. Of course, along with tax raises, Greece needs to also strengthen their public administration and accounting standards.

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