JustJobs NETWORK

Emerging from Debt, Creating Jobs: Lessons from Greece

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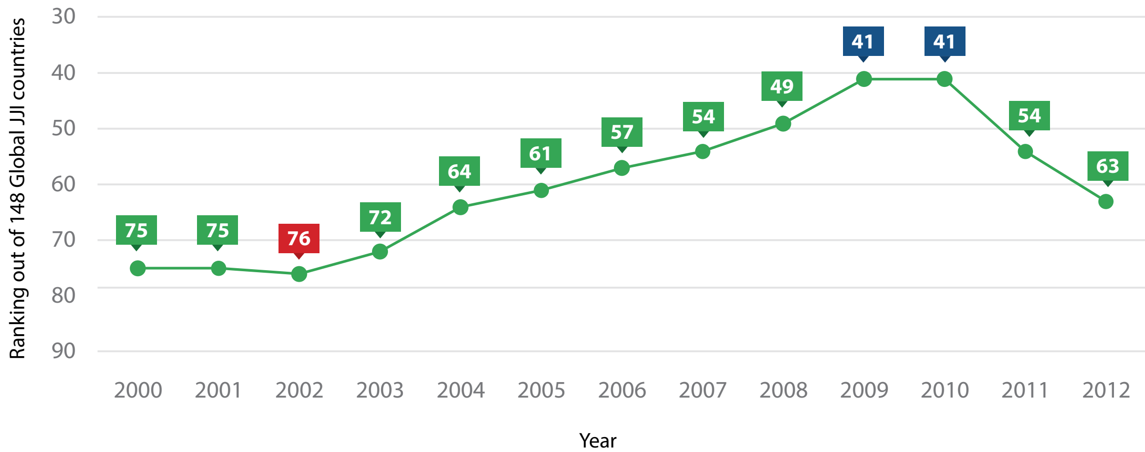
GREECE ON THE JUSTJOBS INDEX

The JustJobs Index measures 148 countries on the macroeconomic indicator that matters most to everyday people : JOBS

GREECE

THREE DIMENSIONS ARE USED TO DETERMINE A COUNTRY'S RANKING

EMPLOYMENT | SOCIAL SECURITY | GENDER EQUALITY



Developed by the JustJobs Network and the Fafo Institute of Applied International Studies, the JustJobs Index is the first-ever global ranking of countries based on quantity and quality of jobs.

INTRODUCTION

Behind the incessant headlines about Greek debt and the ramifications of a "Grexit" lies the stark reality of what this crisis means for regular Greek citizens. The most striking component of the Greek crisis is its impact on jobs. One out of four Greeks is unemployed – a figure matching the United States during the Great Depression. Youth unemployment stands at over 50 percent. Greek minds are focused on this human impact of a crisis often reported through the abstract lens of finance. Addressing the country's employment challenge is as urgent as addressing financial contagion.

The ongoing crisis in Greece has its origin in three problems. The first historical cause is an economy that did not meet many of the preconditions[1] for joining the European Union to begin with (see **Table 1**). The second cause was rampant mismanagement of the Greek economy – lax tax collection and crony capitalism that distorted labor markets. The final cause was the 2008 global financial crisis, which amplified the consequences of the first two.

Greece now owes 323 billion euros to foreign creditors, multilateral agencies and to its own banks. How Greece resolves this crisis will have significant global economic, social and geopolitical ramifications. At the heart of the issue are also fundamental questions about the European Monetary Union as a bedrock of the European unification project.

Greece is not unique. Sovereign debt and its sustainability is becoming a widespread concern. Once the nearly exclusive concern of Sub-Saharan African countries, national debt is now a pervasive problem, not only in southern Europe but also in North American economies like Puerto Rico. This report maps the four likely scenarios Greece faces, but these could very well be the choices other countries face in the near future.

Two of these scenarios are around a Grexit – situations where Greece leaves the European Monetary Union (EMU) and, consequently, the European Union (EU). The other two scenarios revolve around Greece staying in the Eurozone.

Table 1

EU Members' Maastricht Convergence Indicators, January 1998

Country	Inflation Rate (%)	Public Deficit as % of GDP	Public Debt as % of GDP	Long-term Interest Rate (%)
Greece	5.2	2.2	107.7	9.8
EU average	1.6	1.9	70.5	6.1
Reference value	2.7	3	60	7.8

Source: Salvatore, Dominick. 2011. International Economics: Trade and Finance. Hoboken, NJ: John Wiley.

This report unpacks the economic consequences of each scenario and charts a policy pathway for the Greek government, with a particular emphasis on employment.

Considering the pathways out of debt that Greece faces, several policy lessons emerge:

1. Greece's economic recovery is predicated on **fixing its trade balance**. Greece imports much more than it exports, currently running a trade deficit of US$ 27 billion. Imports – both private and governmental – are a major expenditure, standing at over 25 percent of the country's Gross Domestic Product (GDP) in 2014.

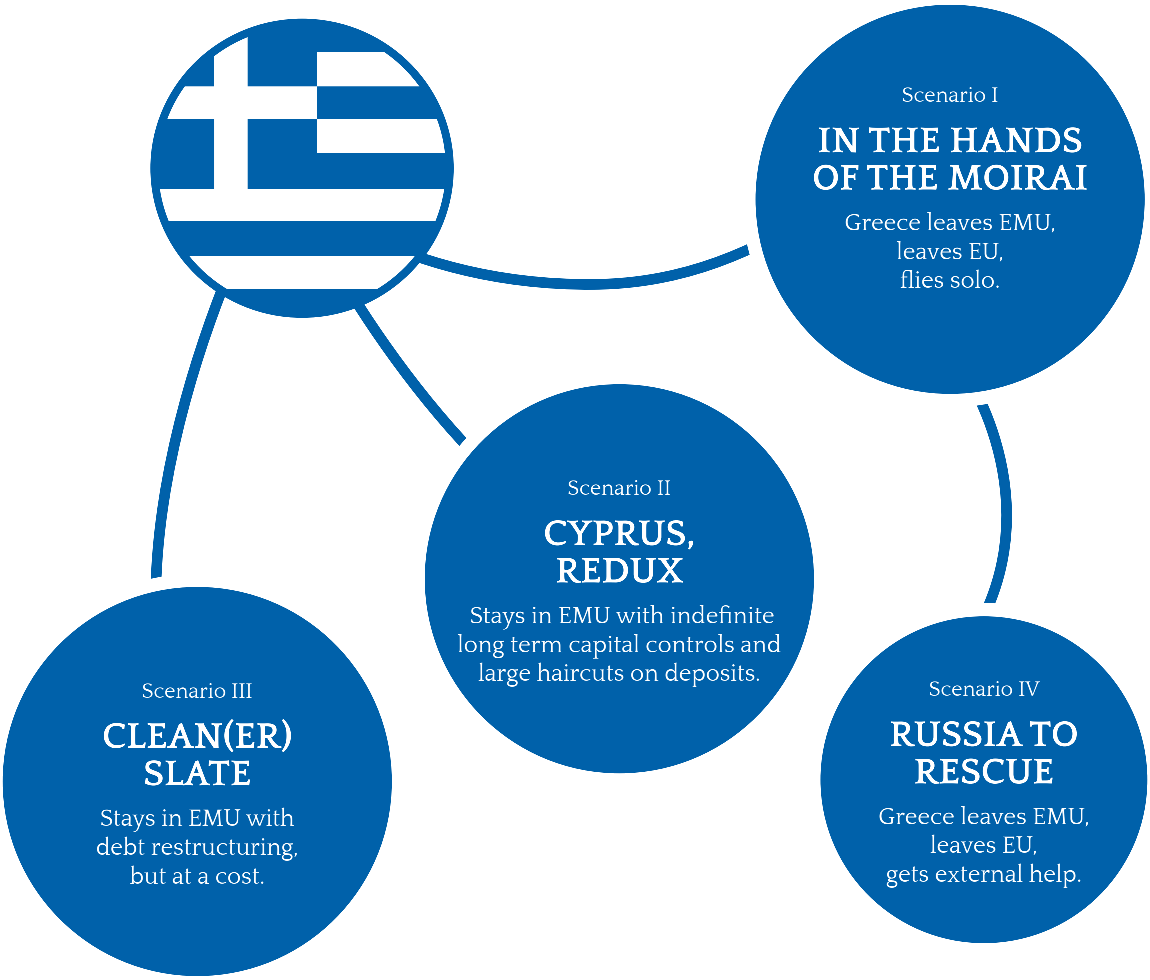
This report maps the four likely scenarios Greece faces, but these could very well be the choices other countries face in the near future.

If Greece exits from the European Monetary Union, a new drachma will be far weaker than the euro and a weaker currency will make foreign imports exceedingly expensive. Greece will then have to put in place a strong import substitution policy – that is, replace foreign imports with domestic products. Some of these foreign goods are essential for its industries; heavy machinery is one of Greece's largest imports. If Greece was to take external help in rebuilding its economy, it will most probably swap currencies rather than using its small foreign exchange reserve. If Greece does stay in the EMU, the EU will have to provide Greece relief in this direction.

2. Small and medium enterprises (SMEs) constitute an important part of the Greek economy, accounting for 72.1 percent of all revenues. In the event of a Grexit, Greece will need to **leverage SMEs for further growth.** Greece will have to promote SMEs through imaginative fiscal measures, which could include a lower tax rate relative to regular-sized businesses, for instance, also referred to as differential taxation. Small businesses also tend to be the engine for job growth. In the event Greece does stay in the EMU – with its gross debt reduced – the EU must support the Greek SME sector, including building the capacity of SMEs to expand production and exports.

3. **Controlling the movement of money in and out of its borders may prove beneficial in rebuilding the Greek economy.** Research stemming from the crisis in southern Europe shows that long-run capital controls – restricting the flow of money in or out of national borders – can reduce unemployment by up to 10 percentage points. This holds both in case of a Grexit or otherwise.

Pathways for Greece



SCENARIO I

IN THE HANDS OF THE MOIRAI

Greece leaves EMU, leaves EU, flies solo

Under this scenario, following the lack of a mutually acceptable agreement between the EU and the Greek government, and a subsequent default on the 3 billion euros European Central Bank payment on July 20, Greece should take the following steps:

1. Introduce a Bank of Greece-backed scrip – a legal "coupon" but not a full-fledged currency for short-term payments to civil servants and pensioners. In parallel, municipal authorities and the private sector would start issuing, and accepting, scrips for small transactions.

2. Move towards introduction of a new drachma and introduce an exchange rate policy that leverages its low value relative to the euro.

3. Introduce a new fiscal regime that (a) promotes micro enterprises through differential taxes, (b) implements strong import substitution policies, and (c) promotes exports.

Let us look at the feasibility and consequences of each step. First of all, the introduction of a state-backed scrip will address the short-term liquidity problem. In terms of recent precedence, California in 2009 introduced IOUs for payment of tax refunds and as payment to county agencies during a deep budget crisis[2]. The California IOUs were accepted – and therefore indirectly backed – by a number of private banks.

A Bank of Greece-backed IOU could at a later date be redeemed in terms of a new drachma, plus interest. The use of such a scrip would be limited; it would not be part of any money market, and therefore not a dual currency. And it will need to be backed – like the California IOUs – by the majority of private Greek banks. The introduction of a scrip is suboptimal since, unlike an actual currency, a scrip is essentially a short-term solution. But the introduction of a scrip would allow the public sector to continue to employ workers. This is significant because the Greek public sector accounts for 40 percent of the Greek GDP[3] and constituted 22.3 percent of all employment in 2011.[4] Without such a solution, the public sector would have to downsize, fueling already rampant unemployment.

From an employment perspective, a fixed exchange rate is actually preferable to a flexible one. Historically, a fixed exchange rate corresponds to a lower unemployment rate.

The introduction of a new drachma will be a much more complicated affair. On one hand, a floating drachma – a new national currency whose value varies relative to the euro depending on demand and supply in the international money market – will inevitably suffer from devaluation. This will make Greek exports cheaper and more competitive. Exports account for 9 percent of revenue for Greek SMEs.[5] Food and beverages are Greece's largest exports,[6] which stand to gain from devaluation. A weaker currency will also boost tourism.[7] In 2012, 64.7 percent of the Greek workforce was employed in tourism and micro enterprises – businesses that employ less than 10 people.[8]

On the other hand, in 2014, Greece ran a USD 27 billion[9] trade deficit. A cheap drachma will undoubtedly make crucial and major imports like machinery, transport equipment and fuels very expensive. A drachma whose value varies depending on fluctuations in currency markets will make Greek imports expensive and volatile.

Given the imbalance of trade, Greece needs to opt for a fixed exchange rate system for its new currency in the short run followed by gradual floating within a narrow prescribed range. One way Greece can achieve this is to revert to the original peg of 340.75 drachmas to 1 euro.[10] From an employment perspective, a fixed exchange rate is actually preferable to a flexible one. Historically, a fixed exchange rate corresponds to a lower unemployment rate.[11]

In the long-run however, a fixed exchange rate along with an independent monetary policy – a country's ability to set interest rates – necessarily means that there cannot be unlimited cash flows in and out of a country.[12] For example, if Greece were to increase its interest rate and keep its exchange rate relative to the euro fixed, it would only see currency inflow. If it decreased its interest rate and kept its exchange rate relative to the euro fixed, it would only see currency outflow. In order to have both currency inflows and outflows – a prerequisite for attracting and facilitating foreign investment – the fixed exchange rate regime would eventually have to be relaxed in favor of a floating drachma.

A cheap drachma – whether in terms of a fixed devaluation in the short run or a weak float in the long run – will imply rising inflation. Any government attempt at increasing revenue purely by printing currency can be a potential cause of hyperinflation.[13] However, short-term and managed inflation is not entirely unacceptable from an employment perspective. Generally, as unemployment goes up inflation comes down.[14] Indeed, inflation in Greece has gone from about 2 percent in 2010 to about -2 percent in 2015,[15] while unemployment has picked up steadily in the same time period, from 10 percent in 2010 to about 25 percent in 2015.[16] A similar argument holds for interest rates in Greece following a Grexit: a low(er) interest rate will imply high(er) inflation which would then imply low(er) unemployment. Though, as noted, an increase in inflation has to be managed as runaway inflation does not correspond to low levels of unemployment.

Micro enterprises alone accounted for 57.6 percent of Greek employment in 2012. A Grexit will demand that Greece leverages this sector the most, since SMEs typically require smaller capital investments for growth.

As noted earlier, SMEs play a very important role in the Greek economy. In 2013, 72.1 percent of all revenues of the Greek economy were from this sector compared to 58.1 percent for all European Union countries.[17] Micro enterprises alone accounted for 57.6 percent of Greek employment in 2012.[18] A Grexit (with limited capital inflow in the form of investments) will demand that Greece leverages this sector the most, since SMEs typically require smaller capital investments for growth. From the employment perspective, SME growth will not require large structural changes to the composition of the Greek workforce. After all, a very large section of the Greek workforce is already employed in that sector.

Leveraging the SME sector would take the form of lower tax rates for small businesses relative to regular-sized businesses. A differential taxation system – different tax rates for different business sectors – can also act to correct the trade imbalance through stronger support for domestic products that substitute for imports, whenever possible.

SCENARIO II

CYPRUS, REDUX

Greece stays in EMU with indefinite long-run capital controls and large "haircuts" on deposits

In this scenario Greece is offered a third bailout by the ECB-EU-IMF troika. On July 8, Prime Minister Alexis Tsipras's government formally requested a package exceeding 51 billion euros. If this bailout package goes into servicing existing debt, it will not contribute to sustained growth in Greece. Clearly, the bailout must be combined with other measures.

One such measure is capital controls, which can be used to restrict outflow of currency from a national economy ("currency export") and restrict the amount of cash residents are allowed to withdraw. It is easier to control the flow of money in and out of a country for a longer duration than it is to prevent domestic depositors from withdrawing their money. Since June 28, 2015, Greece implemented such controls, restricting daily withdrawal of cash per card at 60 euros and capping the size of allowed transfers to foreign banks. Capital controls have severely hit private businesses' ability to import, they have caused widespread panic about the sustainability of Greek banks and, most importantly, put severe constraints on private consumption.

Yet, for a crisis-hit economy, long-run capital controls in form of restriction of capital inflows and outflows can serve as a valuable policy tool. In an economy where nominal wages, as opposed to real ones, are inflexible and cannot be decreased, capital controls can be used to overcome unemployment caused by such rigidity. It works like this: In a country without capital controls, capital outflows can cause aggregate demand to fall. In that situation, employers will seek to lower wages to cope with the reduced demand. However, whenever such reduction in wages is not possible, employers may lay off workers, fueling a rise in unemployment.

Imposing capital controls prevents this dependence of employment on inbound and outbound money flows. A model for a country in a currency union with inflexible nominal wages – and Greece fits the bill – was recently developed in the literature.[19] This model estimates that long-run controls (on capital inflows) in a small open economy can reduce unemployment rate by 10 percentage points.

Another measure is referred to as "haircuts" on bank deposits. This means that any uninsured deposit above a certain prescribed amount is seized by the state or the central bank through its intermediaries. This is often adopted as a last resort to reduce the size of banks' liability, and acts as a "bail in" for soon-to-fail banks. Such a measure can, to an extent, assuage a lack of confidence in the financial system.

Greece's neighbor Cyprus successfully implemented both these measures. Cyprus's story is remarkably similar to that of Greece's, even though its banking sector is much larger. In the spring of 2013, the EU-ECB-IMF troika agreed to a 10 billion euros bailout in return for strict capital controls and haircuts on deposits above 100,000 euros.[20] In the past two years, Cyprus has made a noticeable recovery. Unemployment has decreased from 16.8 percent in 2013 to 16 percent in 2015.[21]

This scenario assumes the following. (1) Unlike Cyprus, a new bailout for Greece will be its third. The troika has to be reasonably confident about the probability of success of the new rescue plan, given that the past two have failed. (2) The depositors hit by haircuts in Cyprus were foreigners – mostly Russians using Cyprus as a tax haven. In Greece's case, the depositors most hit would be domestic. For Tsipras to agree to such a plan, he must be certain that the domestic political fallout can be contained.

Capital controls and haircuts on bank deposits alone cannot lead to economic growth. In fact, some theorists would argue that capital controls can never lead to long-term growth since they prevent countries from receiving much needed financial investments from outside. Such investments could go toward building infrastructure and creating jobs. Should this scenario play out in Greece or elsewhere, any use of capital controls and haircuts must be accompanied by measures to revitalize employment-based growth.

SCENARIO III

CLEAN(ER) SLATE

Greece stays in EMU with debt restructuring, but at a cost

At the heart of the current Greek drama lies the size of the Greek government's debt, which stands at 323 billion euros, or 175 percent of its GDP (see **Chart 1** for the decomposition of the debt). The magnitude of this number makes debt repayment a major burden on the Greek economy.

Greeks and the European left are increasingly demanding that Greek debt be "restructured." This means one of the following three actions:

1. A debt write-off in which creditors literally forgive all or part of Greek sovereign debt and thereby take it off the books. This is the most extreme form of restructuring.

2. An extension of maturity period at more favorable interest rates. In turn, creditors are protected from outright default and can at least minimize their losses.

3. Shifting the use of bailout funds from servicing existing debt to investments in the real economy. This could take the form of a lower interest rate on the existing debt, then allocating the "savings" towards investment in human and capital infrastructure to modernize Greece's economy.

The prevalent political mood in Germany – Greece's largest lender, holding about 56 billion euros of debt – will most likely not allow for a debt write-off. An extension of the maturity period has been raised repeatedly in the context of Greek bonds as well as international loans. However, any extension of the maturity period will drive up the high price of Greek bonds even further,[22] and it would lower the value of the loans that have already been made to Greece. The only restructuring that is politically feasible and economically sound is shifting the use of bailout funds from servicing existing debt to investments in the real economy.

According to the Brussels-based think tank Bruegel, Greece spent 2.6 percent of its GDP in interest payments last year,[23] and other estimates are as high as 4 percent. An interest rate of 2.6 percent on existing Greek debt works out to 6.3 billion euros. A 1 percent decrease in interest rates would save Greece 2.5 billion euros. The troika should see that this 1 percent cut might be better than an outright default on all debt.

Based on the type of goods Greece already exports, it is feasible for the country to become a manufacturer of sophisticated information technology and laboratory equipment.[24] Savings from debt restructuring benefits could be used to develop a workforce skilling program that enables Greece to "move up the value chain."[25] The troika should also keep in mind that a very large component of economic growth comes not from increased capital and labor inputs, but from increases in productivity of capital and labor put together. [26]

The real obstacle to optimism in this regard is Greece's demographics. Forty-three percent of the Greek population is aged 25-54 years. Re-skilling an ageing working-age population overwhelming engaged in the services sector (72.4 percent of the workforce in 2013) is a much steeper challenge, though not insurmountable. A large-scale on-the-job training program could help Greece retrain its working population. The same goes for any drastic cutback on public sector employment, which the troika would likely demand.

Chart 1

Greek Debt Composition

Source: Open Europe, IMF, EFSF, Greek Public Debt Management Office, IESEG

Bailout Breakdown :

SCENARIO IV

RUSSIA TO THE RESCUE

Greece leaves EMU, leaves EU, gets external help

This particular scenario is the one with the biggest geopolitical import. Under this scenario, failing an agreement between EU-ECB and Greece, that country exits the EMU and the European Union, with Russian and/or Chinese support. This scenario is essentially a replay of Scenario I with the added twist of external players whose long-term interests in Greece may be geopolitical in nature. This scenario could unfold in the following way:

1. The latest Greek request for a third bailout is either rejected by the European Union or not ratified by one or more national parliaments. Alternatively, an agreement – which the Greek far left and far right perceives to be against the spirit of the vote in the July 5, 2015 referendum – causes the Tsipras government to fail. In the ensuing power struggle, fringe anti-EU elements in Greece come to power and abrogate any agreement.

2. Greece misses the ECB payment due on July 20, thereby causing that institution to freeze any further support.

3. An agreement between ECB-EU and Greece fails to soothe the nerves of depositors. Following an agreement, Greece decides to lift capital controls, but ends up causing a bank run and currency outflows. This, in turn, shakes faith in the ability of an intra-Europe agreement and paves the way for a third player.

Under this scenario, the Kremlin steps in to support Greece, either multilaterally through the New Development ("BRICS") Bank (NDB) with

China, or unilaterally. In both cases, the most likely economic support to Greece will come in form of "currency swaps" between Russia, China, or the NDB and a new drachma. A currency swap is an agreement between two nations to trade using their domestic currencies only, undercutting the need to use a third currency. Such a swap would allow Greece to pay for imports using its new local currency and thereby protect its dollar and precious metal reserves.

This scenario is plausible given that 14.1 percent of all Greek imports are from Russia. Another 4.6 percent are from China.[27] In terms of the import bill, Russia's share is about US$ 9 billion and China's about US$ 3 billion.

An indirect Russian bailout would have significant political and economic costs for Greece. As an act of strategic retaliation, the EU might fast-track Turkey's entry into the union, which could prompt Greece to increase its military spending. If a Russian bailout causes eventual friction between Greece and the rest of NATO, military spending would increase even further – increasing, rather than curbing, public expenditure.

An indirect Russian bailout would have significant political and economic costs for Greece. As an act of strategic retaliation, the EU might fast-track Turkey's entry into the union, which could prompt Greece to increase its military spending.

The silver lining for the Greeks would be that, freed from EU constraints, the country could continue a deficit-spending growth strategy. This would depend on long-run lowering of yields on Greek government bonds. Beijing could step in here by facilitating the sale of Greek bonds in Chinese markets, or embarking on a plan to acquire Greek assets at fire-sale values. If the Great Depression – and Keynes – taught economists and policymakers anything, it was that the fastest method of decreasing unemployment is through massive government spending, not by cutting it.

Conclusion

Irrespective of which one of these scenarios play out, the lessons from the Greek crisis have wider applicability.

One lesson is that problems emerge when the real and financial economies are deeply intertwined. The current crisis points to the urgent need for a de-coupling between the real sector – responsible for growth-enhancing investments in employment, infrastructure and social protection, among other things – and the financial sector, which is fueled by large-scale speculation.

The second lesson is that currency unions should also be fiscal unions, where a unified spending and revenue-generating plan is implemented and enforced. A currency union that forms the basis of a political union and not a fiscal one is, as Greece has taught us, ultimately unstable. A true fiscal union governed from Brussels also needs to be democratic in nature. Uniform fiscal and social policies would also ensure that all citizens of the European Union receive the same social benefits – including unemployment benefits and access to re-skilling programs.

The Greece crisis offers valuable insights about sovereign debt, dramatic reduction in public expenditure – "austerity" – and, ultimately, about problem economies on the periphery of the world's largest currency union.

The third lesson is about the sustainability of sovereign debt. Debt traps have perplexed development specialists for most of the 20th century. Once a country is caught in a debt trap – where the sole purpose of a growth-driven surplus is repayment of existing loans – it is very difficult for that country to break out and reinvest the surplus in economic reconstruction. Advanced economies have worked long and hard to establish a stable relationship between growth and jobs, with more making the way for the other. A recent study covering 20 advanced economies showed that 1 percent growth in GDP corresponds to a 0.5 percent increase in employment.[28] Sovereign debt must not get in the way of this relationship. This realization was key to the mid-20th century cancellation of World War II debts. What Europe now needs is a coherent and pragmatic view of national debt, especially when the indebted countries are part of the same currency union.

The Greece crisis offers valuable insights about sovereign debt, dramatic reduction in public expenditure – "austerity" – and, ultimately, about problem economies on the periphery of the world's largest currency union. These lessons will undoubtedly drive the choices Spain, Portugal and Italy make in the coming years. Beyond the political economy of debt in a currency union, the Greece experience also point to the challenges of reconstructing an economy hit by financial crisis. The challenge of carving an employment-generating pathway out of debt faces Greece today, but it will confront other economies tomorrow.

Endnotes

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WORKING FOR SHARED PROSPERITY

JustJobs Network is a private, nonpartisan organization finding evidence-based solutions to one of the most pressing challenges of our time: How to create more and better jobs worldwide. We produce empirical research on good job creation, focusing our work on the critical knowledge gaps in the global employment landscape.

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