

## **The Greek Economic Crisis and Lessons Learned**

Testimony before the Subcommittee on Europe and Regional Security Cooperation  
Committee on Foreign Relations  
United States Senate

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Chairman Johnson and other members of the Foreign Relations Subcommittee on Europe and Regional Security Cooperation, thank you for inviting me to testify at this hearing on the “Financial Crisis in Greece - Implications and Lessons Learned.” As requested I will consider lessons that the United States can learn from the Greek financial crisis, comparisons between U.S. and Greece debt, and implications of Greece’s financial crisis in shaping future economic policy in the United States.

### **Lessons that the United States Can Learn from the Greek Financial Crisis**

The Greek economy has been performing terribly by any measure. The economy has shrunk, with real GDP falling by an average of -5% per year for the past five years, and over the longer term economic growth has been very low. Since Greece joined the European Union in 1981 real GDP growth has averaged only 0.9% per year and productivity growth (on a total factor basis) has averaged only 0.1% per year.

Looking back in time, there are three key factors that have led to this situation, and all provide lessons for the United States:

First, Greece’s economic policies--regulatory, rule of law, budget, tax--have been very poor, as has been documented by many observers. According to the Heritage Foundation’s index of economic freedom, Greece ranks 130 among the countries of the world, the worst policy performance in Europe and on a par with many poor sub-Saharan African countries. According the World Bank’s Doing Business indicator, Greece ranks 61, which is well below Portugal, Italy, Spain, Ireland, Germany, and France; and on two important pro-growth measures in the World Bank’s Doing Business indicator it ranks 155 on enforcing contracts and 116 on registering property. And, by yet another measure, the Fraser Institute’s Index of Economic Freedom, Greece ranks 84 in the world.

These factors alone explain much of Greece’s poor economic performance. For this reason in their latest report on Greece, the IMF (2015) concludes that “To achieve [productivity] growth that is similar to what has been achieved in other euro area countries, implementation of structural [supply side] reforms is therefore critical.” No quantitative measure is perfect and there are exceptions, but there is a general association between these economic policy measures and economic performance.

Of course, U.S. economic policy scores higher according to these quantitative measures and one must be careful in drawing analogies and lessons. Nevertheless there is a problem: The United States has been declining in recent years on all of these measures of good economic policy. On the Fraser Index, the United States ranked 2 in the year 2000, and it ranks 14 today. On the Heritage Index it ranked 5 in 2008, and it ranks 12 today. On the World Bank's Doing Business Indicator it ranked 3 in 2008, and it ranks 7 today.

I have also noticed such a deviation from good economic policy in the United States in recent years and wrote about it in my book, *First Principles*. I find a connection between our current economic problem of low economic growth and this deviation from sound policy principles. In the United States adherence to the principles of good economic policy has ebbed and flowed over the years, creating waves of bad economic times and good economic times.

A second problem for the Greek economy is that there is only one monetary policy—one policy interest rate—set for all countries in the Eurozone, and that includes Greece since it adopted the euro. In particular the interest rate set by the European Central Bank (ECB) a decade ago was too low for Greece, and this encouraged excess borrowing and a housing boom, and eventually a bust and a huge debt overhang by 2010. The higher nominal wages and prices in Greece in the boom years also negatively affected Greece's competitiveness due to the single currency.

While the United States is not in a currency zone with other countries, there is a lesson for the United States here as well. During the period from 2003-2005 the Federal Reserve set interest rates too low and this was likely a cause of the excess risk-taking, borrowing, and the housing boom which ended in a bust and the financial crisis. In my view, this was also a deviation from good economic policy that led to poor economic performance.

A third problem for the Greek economy is a large unsustainable debt and the decision in 2010 the International Monetary Fund started making loans to Greece without first insisting on the Greek debt being sustainable. The IMF broke its own lending rule—that it should not loan to a country with an unsustainable debt—when it did so, with the United States voting to go along. This bailed out the private sector, and has left public institutions (the IMF and other European countries and their taxpayers) holding the bag.

The resulting acrimonious policy and debt negotiations have created political instability and confusion in Greece with deteriorating economic policy and continued low economic growth being the result. The debt problem has also caused difficulties for the Greek banks that hold some of the debt and thereby the Greek payment and credit system. The Greek prime minister's surprise pullout of the talks with the IMF, the Eurogroup and the ECB last month, his call for a referendum, and now the universal recognition that a third bailout is needed, are symptomatic of the political and economic instability. The lesson is clear for the United States as the Congress considers increasing the U.S. quota contribution to the IMF: it is a mistake to break the rule about not lending to a country with an unsustainable debt.

## Comparisons and Causes of the Increase in U.S. and Greek Debt

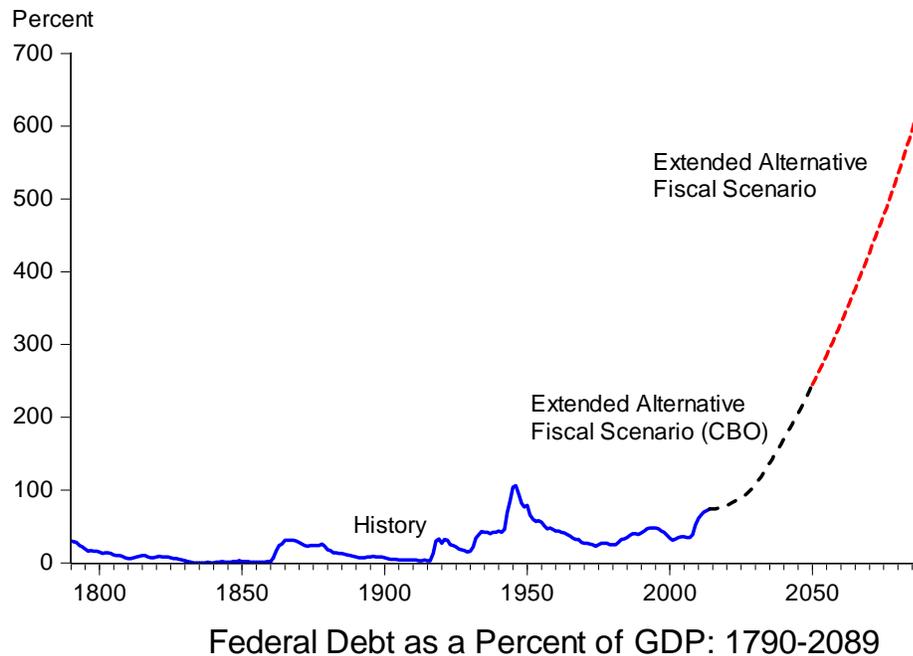
This summer the Congressional Budget Office (CBO) released its 2015 Long Term Budget Outlook for the United States through the year 2089. It shows that under its extended baseline assumption, the Federal debt will continue to rise as a share of GDP from 74% today to 80% in ten years and to 100% in 20 years.

However, the alternative fiscal scenario is a more useful assumption than the baseline scenario. The alternative fiscal scenario, in contrast to the baseline scenario, assumes that certain likely policy changes will actually occur. For example, compared with the extended baseline it assumes that Medicare's payment rates for physicians stay at current levels rather than fall, that expiring tax provisions are extended, and that federal revenues after 2024 remain equal 18.1% of GDP rather than rising as a percentage of GDP.

Under the extended alternative baseline scenario, debt grows to 89% of GDP in ten years and to 139% of GDP in 20 years. For some reason, the CBO no longer report debt levels higher than 250% of GDP, as it has in the past, though it does publish the primary deficit through 2089. Under the assumption that the interest rate remains at the levels reached for the last ten years of the reported debt forecast, I estimated the debt to GDP ratio using the primary deficit for the entire length of the CBO outlook.

The results—both the CBO's extended alternative fiscal scenario up to a debt 250% of GDP and my calculations in later years—are shown in the following figure. The large spike in U.S. federal debt at the time of World War II looks quaint compared to the explosion of debt if policy is not changed. Clearly the future debt picture is not sustainable. A fiscal consolidation—a reduction in the primary deficit, the difference between revenues and non-interest spending—is needed if the debt explosion is to be avoided. That the debt is projected to grow relatively slowly as a share of GDP for the next 5 or 6 years has led to complacency, but the longer the fiscal consolidation is postponed the harder it will be to carry out without disruptions. Moreover, uncertainty about how the fiscal consolidation will take place—spending growth reductions, tax increases, additional debt ceiling debates, sequesters—is likely to be a drag on the economy.

The decrease in the debt to GDP ratio in the late 1990s, observable in the graph, was largely due to a decline in defense spending as a share of GDP coupled with strong economic growth. The increase in recent year is due to the weak economy—the recession of 2007-2009 and the slow recovery. The projected increase in future years is mainly due to the rapid growth of entitlement spending compared to GDP.



How does the Greek debt situation compare to that in the figure above? The political volatility over Greece in the Eurozone and debates and delays over economic reform, create a volatile situation with estimates changing frequently.

At the end of 2014 the debt to GDP ratio in Greece was about 175% percent, and the IMF estimated that the debt to GDP ratio would decline to 105% of GDP by 2022. On June 26 of this year the IMF raised significantly its estimate of the debt to GDP to 142% for 2022 due to deteriorating growth and lack of reforms. Only a few weeks later on July 14 of this year, the IMF again raised the estimate by a large amount to 170% of GDP in 2022. And even with these increased estimates, the IMF says the projections remain subject to considerable risk of a worse outcome.

As the recent increased debt estimates illustrate, the source of the high debt to GDP ratio in Greece is largely due to the weak economy, which in turn is due to increased or expected increases in tax rates, unanticipated or sudden cutbacks in government spending, and the lack of pro-growth reforms. The IMF views the debt situation as unsustainable and is calling for substantial reduction in the Greek debt, which is now held mainly by governments.

### **Implications of Greece’s Financial Crisis for Future U.S. Economic Policy**

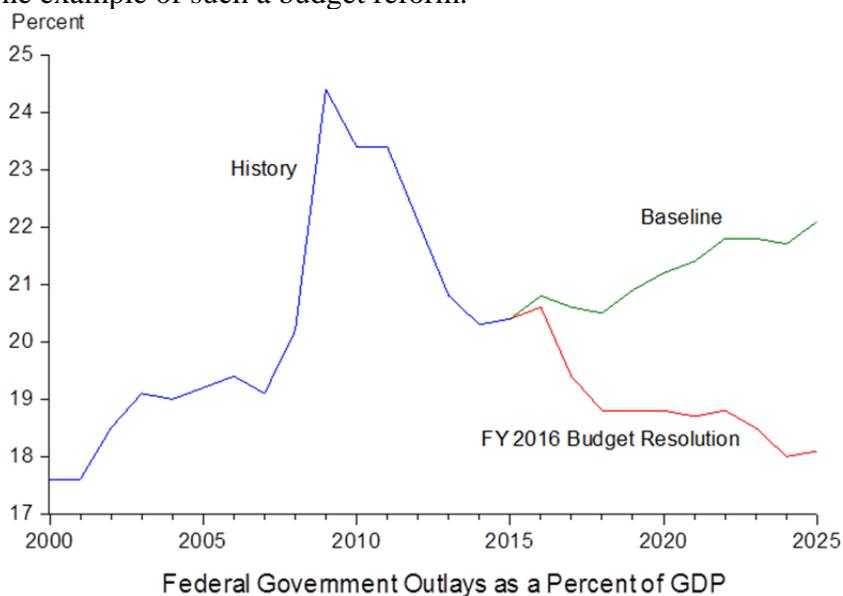
The lessons summarized above have clear implication for economic policy.

Of course, there are implications for Greece: the best policy for Greece would be to change radically economic policy in a pro-growth direction, for example, by making it easier to start-up businesses, ruling out tax rate increases, gradually reducing the size and number of government interventions in the economy. These would start to move Greece up in the economic

policy indexes and, more importantly, increase economic growth and job creation, and reduce the debt to GDP ratio.

For the United States, the policy implications are similar, though their purpose is to accelerate the slow upward pace of the economy—say from a 2% growth rate to a 4% growth rate—and avoid an economic disaster, rather than to stop a precipitous downward drop in the economy and get out of an ongoing disaster, as in the case of Greece.

Economic reforms to control the growth of spending in a gradual and credible way would prevent a debt explosion in the United States. They would increase economic growth in the long run as well as in the short run as I testified at the House Budget Committee in June (see Taylor (2015)). Gradually reducing spending over the next ten years as a share of GDP to the levels experienced around the year 2000—as indicated by the path in the FY 2016 Budget Resolution shown below—is one example of such a budget reform.



Beyond that, a credible legislative or even constitutional agreement to hold the growth of spending to the long term potential growth of the economy would avoid the debt explosion and the damage that would cause.

In addition to a fiscal reform that would defuse the debt explosion, the policy implications point to:

- monetary reform that leads to a more rules-based monetary strategy,
- bankruptcy reform that ends bailouts of too-big-to fail financial institutions,
- international finance reform to prevent loans to a country with unsustainable debt,
- tax, regulatory, and trade reform that would substantially reverse the decline in various indexes of economic freedom and raise economic growth .

Thank you. I would be pleased to answer any questions that you may have.

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