Seven Myths about the Greek Debt Crisis*

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ABSTRACT: In Greece and other countries of the eurozone there are a number of misconceptions about the debt crisis. I argue against seven of such misconceptions (or, myths) about the effects of default, the primary cause of the crisis, the likely effects of an exit from the eurozone, the bargaining power of the Greek government in its negotiations with the EU/ECB/IMF troika, and others. Default and exit from the eurozone appears to be the most viable alternative in the long run; such a move would seem to require considerable preparation under short time constraints and a government with broad political support.

Keywords: Eurozone, Greece, debt, default.

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In reporting and in opinions presented in the mainstream Greek press there are a surprising number of misconceptions and myths about the causes, consequences, and available policies to combat the crisis. Some of the misconceptions are consciously propagated by the government and mainstream media while they know that they are untrue. Other misconceptions might be apparently believed by government officials, those close to them and most of the press.

Many Greeks who are not economists or experts consciously or instinctively understand that there is a serious problem with the dominant narrative, but they do not have the knowledge to argue in detail against the misconceptions. Moreover, many of those who know better and could argue against the misconceptions either self-censor or have difficulties in accessing mainstream media.

A subset of the misconceptions is also prevalent in the global press and propagated by European politicians, bankers, and journalists. My sense is that, curiously, there is less debate and fewer challenges to misconceptions within eurozone countries than outside of them. Perhaps this is because outside observers are less constrained in expressing their independent assessment of the problems facing the eurozone and Greece.

I argue against the following seven myths:

- Myth #1: Default or "bankruptcy" would be catastrophic for Greece.
- Myth #2: The troika's objective is to "rescue" Greece.
- Myth #3: The main cause of the crisis is the corruption of Greeks and the Greek State
- Myth #4: If only the Greek government were competent, the targets of the Memorandum would not fail.
- Myth #5: Following the troika's policies will lead Greece back to prosperity.
- Myth #6: Exit from the eurozone would be the worst possible outcome.
- Myth #7: In its negotiations with the troika, the Greek government has very little bargaining power.

I consider each myth in turn and offer some concluding remarks at the end.

Myth #1: Default or "bankruptcy" would be catastrophic for Greece.

From the beginning of the crisis this myth has probably been the most repeated and very insistently so by Mr. Papandreou and other government officials. In February of 2010, when such utterances first appeared, it would have been difficult to imagine that government officials would continue to do so unchallenged for so long.

It should be noted at the outset that the agreement of July 21 includes a provision that the Greek Finance Minister has already called "selective bankruptcy" whereby existing bondholders were supposed to receive a 21 percent "haircut" through lengthening of the terms of their bonds and a lower interest rate. Thus the scaremongering about default and "bankruptcy" does not make sense when the Finance Minister himself has already admitted that his government has agreed to go through one already. The October 26 agreement calls for a higher 50 percent haircut, though these numbers cannot be taken as a serious indication of the total debt's effective reduction.[1]

One source of the confusion could be the usage of the term "bankruptcy" which has a bad connotation in Greek, especially in connection with personal bankruptcy. It brings to mind images of total destitution, perhaps even indentured servitude. For modern capitalism, though, bankruptcy and debt default along with limited liability are key features.[2] With limited liability for the borrower it is also the lender's responsibility, not just the borrower's, that loans would be repaid. This, in principle, ensures that not too many bad loans are made and the financial crisis that began in the US shows what occurs when lenders become irresponsible in that system. Thus, debt default and bankruptcy for individuals and corporations are critical attributes in the functioning of modern capitalism. If the lender has not been careful in choosing his borrowers, then it is both economically efficient and fair that he loses.

But there are at least three differences between default and bankruptcy, on the one hand, by individuals or corporations and, on the other hand, by sovereign states. First, states do not literally go bankrupt, in the sense that there is no higher supranational ultimate authority and courts that will decide and enforce how the country's assets will be allocated between the different creditors and what will remain with the country's state. Instead, bonds and loans are issued according to the laws of specific jurisdictions, but with the ultimate enforcement can be difficult since states are sovereign. As can be expected though when big interests are involved, posturing, bargaining, and even gunboat diplomacy can play a role on what occurs in the event of default. Legally, the vast majority of Greek debt issued before 2010 is governed by Greek law. In the event of default on that debt, Greek courts have final legal authority. The EU/ECB/IMF troika debt has been issued according to English law and defaulting on that debt would be considerably more difficult than that issued under Greek law. If one of the agreements of

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[1] A 50% haircut would not bring significant reduction of Greek public debt. There are two issues with the gross (over)reporting of the haircuts. First, they do not apply to troika debt or bonds held by ECB and possibly to some other public entities. Thus, a 50% haircut on this partial debt would be something less, say 30%, of total debt. Second, a 50% haircut on the remaining debt is not a 50% reduction in principal (which is what it should be if it's a straight write-down). Instead, it's a combination of making the term of the bonds longer (say, doubling from 10 to 20 years) by issuing new bonds at a lower interest with perhaps some small reduction in principal. Then, the "estimated" haircut depends on how you discount the future and the higher you discount the future, the more miniscule is the Present Value of payments that the bond will pay in the future and therefore the higher the implied or estimated "haircut" today. In the July 21 agreement, for example, they reportedly used a discount rate of 9% to arrive at the reported haircut of 21% when more normal discounting (like market interest rates) might have yielded something like 10% of private debt. Therefore, one cannot accurately estimate the real reduction of debt unless one knows exactly which part of debt is excluded from the negotiations, the exact conditions of the new bonds that are issued in exchange for old bonds and the discount rate assumed in the calculations.

[2] If, as in the old days, the lender could go after all of a borrower's assets and even enserf him or her so as to ensure full repayment, then the lender would have no incentive to provide loans that have a high chance of being repaid and would use lending primarily as a form of acquiring the borrower's assets, including possibly his labor.

July 21 or October 26 were to be ratified, the bondholders would receive bonds that would be governed by English and not Greek law, thus making further "haircuts" more difficult.

The second important difference of sovereign debt from other debts is that it is issued and controlled by government officials on behalf of the country and its people. There can be a big difference, however, between the interests of government officials and the interests of the country and its people. One extreme case of such a difference in interests is that of former President Mobutu of Zaire whose international loans were mostly diverted to foreign private bank accounts with the country seeing no benefits and stuck with paying back the loans. But even nominally elected government officials can be parties to loans that are illegal or odious and, thus, there might be a legal or moral basis for negating such debts. Given the numerous scandals that have rocked both governing political parties, all previously issued Greek debt needs to be scrutinized for possible illegality and odiousness. For example, the contracts with the investment banks that underwrote bond issues, and the records of their implementation need to be opened as a matter of basic transparency and democratic accountability.

The third difference is that sovereign debt rarely, if ever, involves explicit collateral. (Of course, one recent exception is Finland's demand for collateral from Greece in order to participate in the EFSF mechanism.) Despite this usual absence of collateral, however, it is has historically been difficult to completely dispose of foreign public debt.

Given that default is routine even in cases of individual or corporate debt and the fact that most of Greece's debt is governed by Greek law, on balance it would it appear that default would not be difficult. Why, then, wouldn't the country default on it immediately?

One reason might be because the country would not be able to access international capital markets again. Greece, though, does not have access to international markets now and will continue to have no access to them by following the current path, precisely because of its high level of debt and the implied high likelihood of default. On the contrary, a generous "haircut" would make the remaining debt sustainable and then foreign creditors who would be more likely to lend to the country, just as they have done for other countries that have defaulted like Russia and Iceland. How fast Greece could come back to international bond markets would depend on the size of the haircut (the higher the haircut, the more sustainable debt becomes) but also on how fast the legal tangles with bondholders last, with longer outstanding legal issues making return more difficult.

Moreover, there are ways to borrow internationally other than through the bond markets, from other sovereign states or from individual financial institutions. Cyprus, for example, recently arranged for a sizable international loan from Russia. Finally, let us also not forget that before Greece entered the eurozone it borrowed very little from abroad even though its debt-to-GDP ratio was high, and that ratio was sustainable precisely because it was internally held and in its own currency.

If Greece had defaulted in early 2010 Greek debt could have become sustainable in the long run with a writedown imposed on bondholders of considerably below 50% of total debt. The country would have had to borrow internally, perhaps issue IOUs (as it has done already), and impose a few modest cuts. The effect of such a policy would have been mildly recessionary.

What was done instead by the troika was to provide Greece with loans so as to cover its budget deficit without default, in exchange for increasingly draconian budget cuts, tax increases, and institutional changes of dubious value. Existing bondholders continued – and continue to this day -- to have their interest and maturing principal fully paid.

The effect of this policy has been a fast downward spiral of the economy. Since debt keeps increasing and the country keeps getting poorer fast, debt is becoming ever less sustainable. The debt-to-GDP went from 115% to 160% in less than two years. As reported in the *Financial Times* of October 22, 2011, a confidential troika analysis of the sustainability of Greek debt is extremely grim, with the baseline scenario projecting ratios of above 130%. But, as with other previous baseline scenarios, the assumptions include rosy levels of proceeds from privatization; with lower levels of privatization proceeds, debt-to-GDP ratios are still projected to be above 150% in 2030.

Despite the extremely grim debt and economic projections, Greek government officials have continually argued against "bankruptcy" and default and have acquiesced to a "selective" one only after it was offered by European officials. Moreover, they had recently argued against the higher haircuts suggested by European officials and adopted in the October 26 summit.

The timidity in defending Greek interests with the troika and Northern European politicians is a common denominator of the Greek government's response to the crisis. How could "bankruptcy" be catastrophic when existing debt is unsustainable according to all disinterested parties and even according to many interested ones, including the German Finance Minister? The question is no longer about whether Greece should default, but rather about the size of the default and whether it should be "voluntary," with the consent of the great majority of bondholders or a unilateral one that involves a minority of them.

Myth #2: The troika's objective is to "rescue" Greece.

This is a meme/myth that is found abroad and has been completely internalized by the Greek government and, until recently, by almost all mainstream Greek media. According to that narrative, all Greeks have been profligate "sinners" and the troika is a benevolent dictator who is not only rescuing them materially now but is also forcing them to transform their institutions in ways that will bring them long-term prosperity.

Let us first review who has gained and who has lost from the "rescue" thus far. Here, the two immediate parties with large stakes were on one side the vast majority of Greeks and on the other side the country's debtholders. Clearly up to this point the vast majority of Greeks have paid dearly whereas the country's pre-existing bondholders continue to have their interest as well as any maturing principal paid in full, although the market value of non-maturing bonds has plummeted.[3]

Alternatives to the troika's "rescue"

Defenders of the government's response typically say that the alternative would have been "bankruptcy" which, of course, according to the myth they propagate (#1) would have been catastrophic. So let us consider the alternative of "bankruptcy" in early 2010. The debt-to-GDP ratio was around 115 percent at the time. If the country had imposed the haircut agreed on July 21 (21 percent, but a real one), the debt-to-GDP ratio would have come down to a bit over 90 percent, a figure that would make debt barely sustainable. A higher haircut would more likely have been required to make the debt sustainable in the long run, but certainly that would have been below the levels contemplated by European officials now.

Defenders of the government's response would then retort that, after a default in early 2010, Greece (i) would be shut out from the international bond markets and (ii) because it did not have a primary budget surplus (the government budget surplus excluding interest on debt), the government would have been unable to pay wages, pensions and its other bills.

While in the short run international bond markets would not have lent to Greece immediately, the bigger the haircut the more easily and faster would Greece have come back to these markets. But these would not have been needed and, in any case, it is probably unwise for Greece to go back to them any time soon. Even if foreign lending from sources other than bond markets were not to become available, ordinary Greeks would have gladly bought Greek government bonds at 4.5% instead of the 2% or lower they had been getting in their bank accounts.[4]

Furthermore, cuts across the board could have taken place but instead of cuts probably more effective would have been part payment in IOUs or bills that could be negotiable, at a discount, and play the role of near-money. Such a move would have also enhanced liquidity in the private sector and prevented the ongoing depression that the troika's policies have induced. Again, a condition for all of these to have occurred is a deep enough haircut, a dreaded "bankruptcy," that would have reduced public debt to sustainable levels in the eyes of everybody, including Greeks.

[3] For a more extensive analysis of the expected losses and benefits of all parties, including citizens of other eurozone countries, see Skaperdas (2011).

[4] Initially, this domestic purchase of bonds would have come from existing assets, primarily bank deposits. To continue this practice for additional years a significant increase in Greece's savings rate would have to take place. The buying of government bonds would have reduced deposits with Greek banks that would have, in turn, induced a combination of deleveraging and financing from the ECB or through the Bank of Greece using the ELA (Emergency Liquidity Assistance) mechanism. The reduction of bank deposits has taken place anyway without this early default scenario.

What came instead were the troika's increasingly brutal budget cuts whose effects have migrated fast from the public sector and the banks to the private real economy where credit has been choked off, especially given the idiosyncratic financing through post-dated checks and other institutional adaptations of the vital small business sector. As the predictable depression deepens, the demands of ever greater budget cuts, unrealistic privatization plans, and wholesale cookie-cutter institutional changes that show no concern for the Greek Constitution or Greek laws and have no hope of working are still peddled to this day as a "rescue" of Greece.

The real rescue was that of bondholders. In addition to Greek banks and other domestic holders, they include French, British, German and other banks that held Greek debt that has now mostly migrated to the ECB.

The welfare of ordinary Greeks does not appear to have figured out at all in the calculations of the troika, not even through its negative feedback effects on the realization of the troika's assumed objectives and the threat a default of Greece poses for the international financial system. According to some accounts, there was a strong debate within the troika between its IMF representatives and the EU/ECB ones. The former - perhaps having learned some lessons from the dismal experience of other countries under IMF programs - were more aware of the macroeconomic consequences of severe budget cuts and tax increases and tried to moderate the demands of the latter. The end effect, though, was that the views of the EU/ECB effectively prevailed. The policies pursued were consistent with the short-run interests of banks from the eurozone center and perhaps with some other private interests; did not appear to take adequate account of the contagion and other risks the policies posed to the eurozone and the rest of the world; and certainly ordinary Greeks were not considered except possibly as "sinners" who need to be punished.

The myth of the "rescue" of Greece, however, has persisted. Moreover, it has had powerful real, negative effects on the politics and economics of the crisis not just in Greece but throughout the eurozone.

First, the framing of a "rescue" has allowed the German and other European elites to divert attention away from the "bailout" of the banking sector and bondholders, although it certainly has not worked to their satisfaction.

Second, it has fuelled populist rage in Northern Europe against the "lazy" common Greeks, precisely those who benefited the least from Greek public debt and who are solely expected to pay the costs of the crisis thus far. It has also diverted attention from the causes of wage stagnation in Germany, which, by the way, is an important factor in increasing Germany's current account surpluses and contributed to the imbalances within the eurozone.

Finally, by internalizing and propagating the myth of "rescue," the Greek government has helped prevent any genuine debate on alternatives within its own party but also in the whole spectrum of the parties represented in parliament, as well as in the press.

Myth #3: The main cause of the crisis is the corruption of Greeks and the Greek State

"The painful adjustment policies now taking place in a number of eurozone countries are a direct result of their adoption of the euro." (Feldstein, 2011, p.5)

Whether Mr. Papandreou said to Mr. Juncker that "Greece is a corrupt country" or not, the uttering likely reflects the views of some eurocrats and of substantial parts of the Greek elites alike. Moreover, and again according to their views, that has also been the cause of the crisis. Hence, in their own eyes, the troika's and the government's "valiant" attempt to root out corruption and reform the whole country from the ground up.

The public sector and corruption

There have of course been many problems with the Greek state and the way the Greek clientelistic political system has been operating.[5] But similar problems with the state exist in Italy and elsewhere. And one can have frustrating experiences with the "bureaucracy" in Germany too – by its nature, a big part of the rule of law and democracy does require extensive rules and bureaucratic organization that may seem less efficient to market exchange (but which are necessary and productive overall). Nobody, of course, likes corruption but there is very little known about how to combat it and it should not be confused with the size of the government sector, as the richer the country is the higher tends to be its government sector as a percentage of its GDP.

Figure 1 depicts the total number of public workers as a percent of the labor force in OECD countries for 2000 and 2008. General government workers are in blue whereas the purple bands include the employees of public corporations (like the railroad and electricity companies). Greece has few general government workers – fewer than any European OECD country in the sample -- but more employees in public corporations than in general government, as well as a higher percentage of public corporation employees than any other country. Still the total percentage of public employees was considerably lower than those of countries like Finland, Slovenia and Estonia and comparable to those of Hungary, Slovakia and the Czech Republic.

Since in other countries many of the services performed by public corporations in Greece are privatized, it is not possible to conclude from this information alone that public corporations in Greece employ too many workers compared to other countries. However, other evidence suggests that many public corporations have been repositories of clientelistic appointments and excessive salaries and pensions. That is, the "fat" and excess might well be in public corporations. Therefore, a major distinction is warranted between public corporations and the public sector proper. Any anti-corruption measures as well as wage and pension cuts should have been primarily targeted in the direction of the former.

[5] Katsimi and Moutos (2010) provide an overview of Greece's domestic political economy before and after the adoption of the euro.

The Greek public sector proper might have its serious problems of internal organization and accountability to its citizens but this is a typical complaint in all high-income countries. The misinformation and generalized demonization of public employees is completely disproportionate and, in the end, self-defeating. Judges, teachers, tax collectors, policemen, firefighters, and a host of other professions are necessary and essential for the economy to function. When you pay judges, policemen, and tax collectors a lot less and you do so in a way that may be perceived as unfair and even illegitimate, you are unlikely to improve their performance and you are very likely to make the problems of the private use of public office even more serious than they were before the crisis began.

Enter the euro

Would Greece have had the experience it has gone through over the past two years (and the deteriorating conditions that can be expected in the future) without the euro? The answer is a straightforward "No." The euro allowed cheaper financing than was previously obtainable by Greek governments and much of it was obtained from abroad instead of, as before, exclusively from domestic sources. This cheaper financing and the borrowing from abroad had the subtle effect of making Greek governments less responsible than they were before the introduction of the euro. Arguably, if we are to judge from the effective dismantling of the elite tax investigation service (SDOE) and other bolder measures in hiring in public corporations, corruption increased and state capacity deteriorated since the introduction of the euro.

Of course, the intention of Mr. Simitis and the other architects of Greece's entry in the eurozone was the opposite. They were hoping that the Greek state would become more responsible and constrained in its fiscal choices, although their own act with the Goldman Sachs swap that helped reduce earlier reported budget deficits gave the strong flavor of what was about to follow.

The introduction of the euro was also hoped to stabilize inflation and reduce the uncertainty associated with exchange rate fluctuations. Instead it brought the disastrous results of the current crisis.

If Greece were the sole country to have run into trouble, one could argue that it was solely Greece's problem and not the euro's.[6] But one country after another has shown signs of trouble. There were problems lurking in the background that surfaced with the financial crisis and the recession that followed. Greece's problem was its fiscal policy and external public debt coupled with diminishing international competitiveness. Ireland, judging from its pre-crisis debt-to-GDP ratio, was the most fiscally responsible country of the eurozone. The culprits there turned out to be private over-indebtedness and its property bubble that led to problems with its banks, followed by the guarantees its government gave to the banks. Portugal had moderate debt-to-GDP ratios but through contagion it was perceived by the bond markets to be the weakest of the rest in terms of

[6] The next three paragraphs are partly based on Skaperdas (2011).

size, low growth, and fiscal vulnerabilities. Spain was also nearly as fiscally responsible as Ireland and it also suffered from a property bubble and high private debt. Italy has suffered from high public debt and persistently low growth over the past decade.

Greece was the biggest violator of the Stability and Growth Pact's budget deficit limits and had the highest public debt. The Irish and Spanish crises can be considered largely an outcome of the unclear supervision of, and gaps in responsibilities for, the banks. Portugal has been a victim of the general economic malaise that it has experienced since adopting the euro and the power of the bond "vigilantes," perhaps more so than any of the other countries since there was nothing specifically that was done wrong. But all countries experiencing a crisis have had, since the introduction of the euro, a large expansion of overall indebtedness, whether primarily public or private, that was accompanied by an increase in their current account deficits. Over the same time period, these deficits were matched by an increase in Germany's current account surplus.[7]

For the eurozone, the problem is not Greek government profligacy or Irish carelessness. If Ireland or Greece were not part of the eurozone, another peripheral country would get into trouble sooner than later. The problem is structural: the weakness of institutions for a monetary union that consists of such diverse and heterogeneous countries that have no independent economic tools other than wage and price adjustments that have been historically known to be crude instruments.[8] The creators of the euro saw it as primarily a political project, as a back-door way of forcing political integration. Political integration, however, never took off the ground and now we have the rather predictable results.

To recapitulate, without the euro it is difficult to imagine how a crisis of such depth would have occurred. If Greece had retained its own currency, with less borrowing from abroad it would have likely grown less than it did up to 2007 but it would have had the tools – a depreciating exchange rate – to weather the recession much better than it did, without being on the brink of default or surrendering all semblance of national sovereignty. With borrowing more expensive and domestic in its vast majority, its governments would have had better incentives to be more fiscally responsible and would have not eroded its tax and other state capacity as much as they did since the introduction of the euro.

Myth #4: If only the Greek government were competent, the targets of the Memorandum would not fail.

This is the only myth that the Greek government does not propagate itself. It is instead what other domestic and foreign defenders of the Memorandum policies want us to believe. The Memorandum targets, however, could not have worked because the effects of the budget cuts were consistently underestimated in the troika's estimates.

[7] See Research on Money and Finance (2010, Fig. 14, 27).
[8] See Ahamed, 2009, for a discussion of the UK's painful and persistent attempt to return to the Gold Standard at pre-World War I exchange rates.

For example, in March of 2011 the IMF's estimate for 2011 GDP growth was -3.0% and for 2012 the estimate was for a positive 1% growth (see IMF, 2011, Table 8). As of last month, the preliminary figure for year-over-year growth was -7.0% while the estimates for 2012 have become negative. As reported in the *Financial Times* on October 22, 2011, the most recent confidential estimates by the troika are even worse.

Since the economy has been contracting much faster than originally estimated by the troika, tax receipts were inevitably lower than estimated and expenditures were higher because of increased spending on items like unemployment insurance. Inevitably, then, the budget deficit becomes much bigger than originally estimated, precipitating hectoring and calls for additional budget cuts and taxes in order for the government to receive the next tranche.

There is no end in sight for this cycle of cuts, new taxes, further contraction of the economy, greater budget deficits than originally estimated, with more cuts and taxes starting the cycle anew.

The Greek government could be highly competent and the objectives would still fail. It is not highly competent, but it still has implemented a large number of measures that were highly unpopular and against stiff opposition. Examples of such measures include:

- Increased the VAT to 23%, from 19% or 13% originally, despite all the calls that it would reduce competitiveness and possibly reduce VAT receipts.
- Eliminated the two "extra" months of pay (Christmas, Easter, and vacation bonuses) and replaced them with fractions of the original pay.
- Eliminated the raises for seniority in the public sector.
- In addition to the above, salaries of public servants were cut by 10% (with additional reductions to come).
- Similar, in some cases higher, cuts as the above were implemented on pensions.
- Equalized the pension requirements for men and women.
- Reduced the tax-free income to 5,000 from 12,000 euros.
- Reduced medical expenditure tax deductions to 20% (from 40%) even for income earned in 2010.
- Considerably increased car registration charges from 2010 onwards.
- Implemented a new special "solidarity" tax from ranging from 1% to 6% of income.
- Increased bus ticket prices by 20% and subway ticket prices by 40%.
- Reduced severance pay that private employers pay by up to 50% (depending on length of notice that is given).
- Introduced new house property taxes.

It is difficult to think of any governments anywhere on earth implementing so many measures within such a short period of time. And this is only a sample of the measures implemented. There are also a large number of other measures that either have not been implemented or are yet to be voted on by the Parliament. Yet the troika and its defenders keep complaining that the government has “not done enough” or is “dragging its feet” and demand more.

One main concern of the critics is the slow pace of liberalizing legal and institutional changes by either taking too long to bring bills to parliament or being too slow in implementing them once voted into law. In addition to the substantive objections one could bring up against wholesale liberalization, it is surprising that such critics expect from a highly unpopular government to just sneak in such reforms expecting no serious pushback, especially from a society that disagrees with most of them, even among conservative voters.

The economic effects of the troika’s policies were largely predictable and the criticism of the government of not being zealous enough in pursuing them reveals, at best, a basic unawareness of the limits democratically elected governments have in going against the wishes of their electorates. Still it is difficult to decipher the behavior of the troika and how it served the long-term objective of the survival of the eurozone as it now is or anything close to it. It could have been just a combination of bureaucratic inertia, making an example of presumed “sinners”, and letting some well-placed interests making a profit out of Greece’s predicament. The behavior of blaming the Greek government for all the problems, however, appears to have markedly changed recently as it gradually dawned on European officials that the problem is indeed systemic and hectoring and threatening the Greek Finance Minister will not save the eurozone.

Myth #5: Following the troika’s policies will lead Greece back to prosperity.

In addition to the more immediate budgetary cuts and tax increases, the troika’s policies include (i) reductions in wages and prices; (ii) legal and institutional changes aimed at liberalizing labor and other factor markets; and (iii) privatization of public property. I will briefly discuss each of the policies, their ostensible objectives, and possible implications. I will then summarize their likely long-term effects.

Effects of reductions in wages and prices

The main objective of reducing wages and prices is for the economy to gain international competitiveness. This is the so-called policy of *internal* devaluation, as opposed to that of *external* devaluation, whereby a country gains competitiveness through its currency’s depreciation which Greece does not have available within the eurozone.

As can already be seen, suppressing wages in such a way is painful, subject to significant resistance, and involves the overturning of much existing labor law. Nevertheless, the already substantial reduction in wages has not translated in a reduction in prices; after more than eighteen months of austerity, the inflation rate is still 2.5%.

Attempts at internal evaluation are well-known to lead to depression-like conditions with high unemployment that lasts for years. The current experience of Greece within the eurozone is similar to that of the UK after World War I when the pound was brutally brought back to its pre-war Gold-standard equivalence. Yet all the pain, as Keynes had warned, was for nothing as the country had to abandon the Gold standard again during the Great Depression (see, e.g., Ahamed, 2009). One major factor that makes internal devaluation very difficult is that, as wages and prices decline, the value of debt does not adjust. That makes debt ever more onerous, leading to both higher reductions in consumption and defaults which in turn lead to credit contraction and further reductions in economic activity and increased unemployment. Then, the cycle repeats itself with no end in sight.

A concrete example might help. Consider a worker with pre-crisis income of 1000 euros a month who had a mortgage of 300 euros a month and other fixed home expenses of 100 euros a month. That would have left 600 euros a month for all other expenses. Now consider a 20% percent – 200 euros -- reduction in monthly income. That would leave 400 euros a month for all other expenses, which is a 33% reduction in actual consumption and other expenses. That is, the percentage reduction in consumption is likely to be higher than the percentage reduction in wages and such reductions can be expected to have additional deleterious effects on the economy.

Furthermore, some of the workers like the one in our example will become unemployed and they are the ones who are likely to stop paying their mortgages and lose their homes, thus inducing a further contraction on credit with additional knock-on effects that can be expected on the economy. This process of debt deflation is an integral part of internal devaluations that make them fundamentally different from external devaluations, and in the end it seems they never work.

An additional factor that is not usually taken into account in economic analyses but often has its own additional negative economic effects is the increased levels of social conflict. That factor manifests itself in many different ways: increased common crime and organized crime, strikes, other work stoppages, or passive resistance in other different ways. These activities have direct and indirect effects of reducing production but also induce their own dynamic of economic decline. Already one can identify such effects in parts of central Athens as a result of rampant crime.

Liberalization

The legal and institutional changes imposed by the troika are meant to both facilitate internal devaluation through the abolition of many existing labor laws and induce structural changes in the economy that will ostensibly contribute to growth. Examples of structural changes that have been pursued include the liberalization of taxis and trucking by effectively abolishing licenses for these professions. Whereas taxi drivers are not the best loved profession in Greece and improvements in their level of service would be welcome, it is hard to see how the contemplated reforms would lead to significantly better levels of service and there is the danger that they would be retrogressive.

As for the wholesale changes in labor law, regardless of the opinion one has about their effectiveness or justice, there is little popular support for them and none of them were part of the program that the current government campaigned on. Thus, it is difficult to reconcile them with a polity that respects the basic democratic rights of its citizens.

What is not pursued, however, is reform of retail and wholesale markets of basic consumer goods and services, the structure of which is largely oligopolistic. The persistence of inflation might be related to this problem.

Privatization

Privatization of public property is hoped to bring in 50 million euros and do so within a short few years. But the question is who is going to buy public enterprises with high debt and difficult labor relations or public land restrained by riders that would invite legal challenges? Whatever is sold in the next few years will be of clear title and high value but it will be at depressed prices. Such sales in turn, are likely to bring future legal challenges on the part of the directors of the privatization company and others.

Overall effects

In the end what can we expect by continuing on the path dictated by the troika?

- Continuing decline of incomes, unemployment, with some reduction of prices of domestically produced goods and services. The decline will likely continue for the foreseeable future, especially with the expected demographic decline. The young and anyone who might be able find employment abroad will leave the country. Thus the most productive segments of the society will stop contributing, reducing taxes further and putting additional pressure on public finances, pensions, and social services.

- Even with a generous haircut of existing public debt, the continuing reduction in the country's income will make public debt a continuing burden. To ensure compliance, EU and German officials will take over the key posts of the country's fiscal apparatus.

- Whether a result of the haircuts imposed on public debt or too much bad private debt (due to the process of debt deflation outlined above), Greek banks will become first nationalized and then sold off to private interests. Those interests are more likely to be foreign, without much connection to the relationships that make banks responsive to local needs.

- Any decision of importance to the Greek people will be taken abroad. There will be little semblance of democracy, self-governance, and national sovereignty, just as it has occurred over the past eighteen months. This, however, would be the peaceful scenario that ignores the effects of extended government illegitimacy usually brings about: social chaos but also resistance movements.

The former East Germany has lost its young and the most productive inhabitants to the former West Germany and Berlin. Those who have remained behind are mostly the old, the infirm, and those employed by governments. Today, more than twenty years after German reunification, a lady from East Germany claims that she can distinguish those who come from the East from those who come from the West, especially men: "West Germans are much prouder. They stand straight. East Germans are more likely to slouch. West Germans think East Germans are lazy." (Lewis, 2011)

By following the current path, the future of Greece is similar to the present of East Germany, minus the transfers and subsidies from Berlin, minus the right to vote in German elections and all the other benefits of German citizenship, but with the addition of a crushing public debt burden.

Myth #6: Exit from the eurozone would be the worst possible outcome.

Having your own currency confers several advantages that had become extremely underappreciated during the boom years of the eurozone.

First, there is little doubt among economists that the easiest mechanism for a country to gain international competitiveness is to have its currency depreciate. With exit from the eurozone, cars and i-phones will become more expensive but food might actually become cheaper. In fact, the introduction of the euro brought distortions in relative prices that economists to this day have trouble understanding, and the introduction a new drachma might help partially reverse these distortions. Regardless of that, though, the benefits of having your own currency as a way of adjusting to international shocks and international competitiveness are well-known and quantitatively important.

Second, having your own currency implies you tailor monetary policy to the country's immediate needs, instead of having it determined by the needs of the most influential country in a monetary union which are unlikely to be aligned with your own needs. This is especially important in periods or recession and depression like the one currently Greece is in.

Third, the experience of the past eighteen months has amply demonstrated that being in the eurozone is incompatible with democracy in Greece and national sovereignty.[9] As discussed above (on Myth #5) following the current path holds more of the same. The only possibility of remaining within the eurozone and Greeks having any say is to have

[9] As developed by Rodrik (2011) and as applied to the eurozone by O'Rourke (2011), there is a fundamental political "trilemma" between democracy, national determination, and economic globalization. You cannot have all three of them simultaneously. By being part of the eurozone (an instance of economic globalization), you normally give up some national determination, but in the case of Greece even democracy has substantially eroded since all major decisions dictated by the troika are voted against strong popular opposition, and arguably in the case of major votes without the 2/3 majority required by the country's Constitution.

political unification of all the eurozone countries with full democratic rights for all the citizens of its constituent countries. That would bring some democratic legitimacy in the eurozone, although that would be the end of all national sovereignties. However, not even political unification is likely, let alone political unification with democracy eurozone-wide.

Democratic legitimacy and national determination are not just abstract concepts that are disconnected to people's everyday lives and their work. For the merchant it implies the government's policy towards banks and liquidity in general takes their interests into account. For the worker it implies that their concerns for unemployment and inflation will have to be heard in Athens instead of (not be heard) in Berlin, Frankfurt, or Brussels. The local industrialist will also have a chance to be heard and influence policy.

Thus, economic reasons, democratic legitimacy, national sovereignty, and even basic dignity are all related and point to Greece having its own currency. Most of those who object to exit from the eurozone are mainly concerned with the costs of transition. Won't the foreign debt burden increase even more due to devaluation? How will the banks adjust to the change in currencies? How will the country import essential items like petroleum and pharmaceuticals? What will happen to bank deposits? Won't all this create total chaos?

Those, and many others, are fair questions to ask. What is important is how competent, honest, and ready to defend Greek interests will be those who manage the transition; how fast and flexible will they be in adjusting as unforeseen problems crop up; how able will they be in articulating their actions to the Greek people so that negative reactions are minimized. A completely uncontrolled and unplanned exit from the eurozone will be chaotic and a lot more painful than a controlled and well-planned one.

Going back to the questions about the transition period, I start with the first one on the debt burden: As noted above, almost all non-troika debt has been issued under Greek law and was contracted in the country's national currency which would have been the euro before the transition but, after the transition, all financial assets and debts would become denominated in the new currency at the rate prescribed on the first day of transition. Legal arguments would be made for and against the denomination of old debts in "new drachmas" but the ultimate arbiter of this dispute would be Greek courts. Since both bank deposits and other debts would also become denominated in new drachmas it would be difficult to argue that public debt should not. This denomination of debts would also provide an incentive to other countries not to encourage a rapid and undue depreciation of the new drachma.

The adjustment of the banking system will take some time with many twists and turns that cannot all be predicted in advance, but the problems should be manageable. As former Czech President Vaclav Klaus mentioned, based on the experience of the breakup of Czechoslovakia and the currency transition there, exiting the eurozone will not involve overwhelming logistical problems.

Naturally, capital controls will need to be imposed and other measures will have to be taken to ration foreign exchange for the importation of essential items.

Bank deposits will automatically be adjusted to the new currency as will be all domestic debts. Inevitably, net creditors will lose some and net debtors will gain in the short run but even net creditors might gain in the long run since the economy can be expected to grow faster than if it were to remain within the eurozone.

The transition will be difficult and painful but, if managed properly, the pain will be short term. With its own currency the Bank of Greece and the government will be able to inject much needed liquidity in a currently dying domestic market due to an extreme shortage of credit and liquidity. The increased liquidity along with the beneficial effects of depreciation through import substitution, reduced imports, and possibly increased exports will bring the economy back to life and increase employment. Of course, the government will have to negotiate a narrow path between increased liquidity and keeping inflation within reasonable levels.

While many economists located outside the eurozone, including figures like Paul Krugman and Martin Feldstein, recognize the benefits or even the necessity of Greece exiting the eurozone, most economists within it have studiously avoided even mentioning the subject. Some studies by banks present scenarios that are rather bleak. UBS (2011), for example, claims that Greece's GDP will be cut in half if it were to leave the eurozone. Leaving aside the fact that Greece's GDP could be in a few years half of what it was in 2009 by following the path prescribed by the troika, the assumption of the study is that any devaluation of the new drachma will be immediately matched by increased tariffs from EU countries. Such a threat of retaliation is also mentioned by others.

The question is who would have an interest in implementing such retaliatory tactics, coordinating them EU-wide, and what would that imply for today's world trading system? To engage in such retaliatory activity, all the EU countries would have to agree, when some of them would also be seriously contemplating exit from the eurozone. Why would they want to effectively foreclose such an option to themselves? Moreover, such a retaliatory tariff would have serious implications not just for the future of the EU but for today's globalized world trading system. It would be the beginning of the end of the world as we know it and every country would want to protect itself and its people from the coming tsunami.

That would actually be an additional argument for Greece having its own currency, so as to maintain maximum flexibility in its economic policies, in a much less globalized and possibly poorer world.

It should be finally noted that the eurozone is likely to break up regardless of what Greece does. The real alternatives are political unification and breakup. Anything in between cannot be sustained, either politically or economically. Since political unification is not in the cards, it is largely of question of when and how the breakup will occur.

In any case, it is highly imperative that, regardless who is in charge of the government, the Bank of Greece and the Ministry of Finance have teams secretly working on the scenario of eurozone exit. That could make the difference between a chaotic exit and a well-planned one.

Finally, a default and exit from the eurozone would not have to be done in an overtly adversarial fashion with Germany and other eurozone countries. Once such a move becomes clear or inevitable by circumstances as it might well become, it would be in the interest of all parties to make its effects as smooth as possible. There are many economic and political constituencies within Germany that would find such a possibility welcome and a mutually advantageous move for Greece, Germany, and for the future of a more cohesive and sustainable eurozone. There would be also no reason for Greece to leave the EU or for other countries to demand its expulsion. The apocalyptic scenarios that are circulated are sometimes just part of the negotiating tactics used by one side to prevent another side from doing what they don't want them to do but they do not necessarily have much basis in fact.

Myth #7: In its negotiations with the troika, the Greek government has very little bargaining power

"If you owe the bank a hundred thousand dollars, the bank owns you. If you owe the bank a hundred million dollars, you own the bank." American proverb

Greece owes enough money to foreign financial institutions so that even if it does not "own" them at least it has enough bargaining power to negotiate for better terms in paying back the bonds and to moderate the troika's austerity demands. Of course, French and German banks as well as the ECB have the backing of the French and German states. But, then, in addition to bank losses Greece also has the threat of contagion to the bonds of other sovereigns as well as the uncertainty that would emerge after a Greek default regarding who has obligations on Credit Default Swaps (CDSs). Both the contagion and CDS problems would freeze the Northern hemisphere's interbank markets.

In addition to having a threat that Greece definitely has with default and exit from the eurozone, there are two other important conditions that enhance one's bargaining position and make a threat credible. First, you have to believe yourself that your interests differ from those of your adversary, and your adversary knows this. If you personally believe that you will be "rescued" by the bank's representatives out of the goodness of their hearts, even if you owe the bank a hundred million dollars, you are definitely not going to own the bank. The bank will still own you. Second, you need to prepare your side for the ultimate threat you have so that the other side has the reasonable fear that you can carry out the threat. If you don't bring a lawyer and other experts with you when you negotiate with the bank and are not ready to signal a default, you could not expect the bank to take you seriously.

As reviewed above, Greece could have defaulted at any time during the past two years and could have used that as a credible threat in its negotiations with the troika. But the Greek government apparently has fulfilled neither of the two important necessary conditions for successful negotiations.

First, it adopted the framing and perhaps the objectives of the troika and even of the German tabloid *Bild* about the country and its people. Its visible members appeared unaware of the difference between the objectives of the banks, of the troika, and the people they supposedly have represented over the past two years. Perhaps they got carried away by the rhetoric about "European solidarity" and "we are all in this together." Such proclamations can be useful but cannot be taken seriously in preparing one's side. Without awareness of the different objectives, no further steps can be taken to create a strong Greek bargaining position. Instead of being an independent actor one becomes *cognitively captured* by the other side.

Without awareness of the differing objectives, the bureaucratic apparatus could not be directed to produce data and arguments that would favor Greek interests. If IMF experts wanted to apply their cookie-cutter approach used in other countries, the Government should have been able to come up with arguments about the harm that particular reforms could induce in Greece. Examples include the harm that some changes in the private labor market would bring about and the supposed 50 billion euros that privatization will yield.

Preparing for the ultimate threat of default and exit from the eurozone requires the formation of teams of experts beyond the limelight and in secrecy. Such preparation necessitates the development of different scenarios, gaming them and testing the robustness of different approaches. Examples of the myriad issues that have to be considered include how to effectively introduce capital controls in case of exit from the eurozone, to how the bank payment systems need to be converted, to how will liquidity be injected into the economy.

Of course, you need to believe yourself that you are willing to carry out the threat if the other side is willing to take everything to the brink, and subtly communicate to the other side that you have made preparations and you are willing to go to the brink yourself.

There is no evidence or other indirect indications that the key members of the Greek government either believed in negotiating or having made any of the necessary preparation to enhance their negotiating positions vis-à-vis the troika.

It is then completely unsurprising that the current Finance Minister was laughed off twice -- in June and September -- when he tried to "negotiate" with the troika. How could it have been otherwise when he and his government were not willing to use any threats, let alone believe in them?

There are opinions expressed that the government needs more technocrats who will navigate the country through the continuing difficult times. Whereas the expert teams referred to above need technocrats, they also need to be led by those believe that the interests of Greeks do not coincide with those of the troika and are willing to defend them.

Some cautious observers as well as defenders of the Greek government's timidity raise the issue of possible national security threats that foreign governments might make if Greece were to take a hard line in bargaining.

Let us note first that very recently countries like Iceland and Hungary have taken very hard lines against the UK's and the Netherlands' wishes (in the case of Iceland) and against the IMF in the case of Hungary. The UK and the Netherlands even made explicit threats if Iceland were not fully to pay back for the losses of the affiliates of Icelandic banks in these two countries. Well, the Icelandic people, contrary to the prescriptions of their terrified political class, voted not to fall for the threats but nothing happened to Iceland. On the contrary, Iceland is preparing for entry into the EU, and nothing bad happened to Hungary either.

The national security threats against Greece would presumably come from Turkey. It is unclear why Germany or another country would have an interest in expending the huge diplomatic and other resources to induce another country -- Turkey – to attack Greece if Greece were to default and exit the eurozone. What would it gain from that, especially after an event not to its liking has already taken place? Furthermore, Turkey's hands are full at the moment and it is extremely unclear how it would enhance its own position by attacking an ostensible ally.

Concluding Remarks

Knowingly or unknowingly, the Greek government and mainstream press have been repeating most of the myths stated and discussed above. They have used them in order to justify the policies they've followed thus far and those they plan to vote on and implement in the near future.

The myths also facilitate a near complete absence of debate about alternatives to the troika's path. Members of parliament who vote whatever the troika asks them to vote use the fig leaf of a combination of the myths and the absence of any well-considered alternatives.

All opposition parties in parliament are also partly responsible for this state of affairs. They complain and object to the current policies but they rarely challenge the myths in a sustained, organized and intellectually honest fashion. Moreover, they have not presented cogent alternatives that could convince PASOK members of parliament to defect or create the conditions for a coalition government that would take a genuinely different path.

It is unclear why misconceptions about extremely important policy decisions can persist in a liberal democracy with reasonably free press. I cannot fully explain such a phenomenon satisfactorily here but a few minor observations might help in beginning to understand the problem.

From the beginning of the crisis Greek government officials and most of the press subscribed to the misconceptions. Then, anyone who argued against a particular misconception was likely to face a number of questions that were partly based on other misconceptions, which made the original argument less convincing or more difficult to make. For example, someone who argues that default would not be a bad thing could face a series of questions about how we would be ungrateful to our fellow Europeans who have been trying to "rescue" us; how the troika has a good plan that will rid the country of corruption and lead it back to prosperity; how default leads to exit from the eurozone and that, of course, is the worst possible thing that can occur; and so on. That is, the myths that I have argued against work synergistically, complementing one another. Believing one of them tends to make one believe the others. When, then, the dominant narrative in the media is to push most of them, it is difficult for any single person or even organization to argue effectively against them without developing their own comprehensive narrative or counterproposals, and that takes time.

Furthermore, when a government is under severe pressure externally and internally, it still has the power of the state apparatus in its control. That's also when there is reason to wield that power in ways that it wouldn't wield in normal times. It can influence the mainstream media gatekeepers in subtle and non-subtle ways, who can in turn affect who appears and how those who appear are framed on TV and major newspapers. Those who do appear in the media and would normally be critical have to think harder than normal about what to say and how to say it in ways that will not offend their hosts. Journalists, pundits, and academics can self-sensor or even abstain from expressing views fearing that they will become controversial or offend some of their colleagues.

There is evidence, however, probably partly as a result of popular pressure and the sheer weight of reality, that most of the myths are loosening their hold in the mainstream media.

This is an opportunity, then, for backbench politicians, or those out of favor and parliament, academics, any others with influence to stop acquiescing when the myths are repeated and need to speak up when they genuinely have a different view. Time is running out.

I conclude with some basic implications for the future of the arguments developed against the seven myths:

- The current path of debt is unsustainable and therefore default is inevitable. It would be surprising if the October 26 tentative agreement for the advertised 50% haircut brings a significant reduction in public debt (see footnote 1 for the reasons). Moreover, just as it occurred with the July 21 agreement, it is unlikely that the vast majority of bondholders will agree in the end. Whether they will agree or not, the effect on Greek public debt and its sustainability will be small. Therefore, the country will need a much greater reduction in debt and that is unlikely to be accepted "voluntarily" by the bondholders.

- Following the current path will involve continuing austerity for the foreseeable future without being able to see any "light at the end of the tunnel." All important fiscal decisions will be made outside the country. The young and skilled who can find jobs abroad will emigrate, leaving behind an older, less productive, and needier shrinking population that would have to endure a crushing debt burden.

- Involuntary default under Greek initiative is, then, the most realistic alternative to the "voluntary" but ineffective defaults periodically agreed upon in eurozone summits. Such a default will be free of the phantom percentage haircuts that appear to be mostly Public Relations initiatives by a Eurozone leadership that cannot offer anything else. It will allow the immediate cessation of interest payments and thus avoid some budget cuts and reduce the continued slide in income. It will also make Greece an active, central participant in negotiations for its debt instead of default being a matter of private discussion between the German Chancellor and the French President.

- Such default would be a very difficult to sustain within the Eurozone as Greece would have to depend on continued funding from the ECB to support Greek banks and pension funds. This and other factors would severely curtail the bargaining power of Greece to reduce its debt, thus possibly negating the benefits of involuntary default. Having its own currency, instead, will allow the country to better support its banks and funds, as well as having the other advantages I have discussed.

- Default under Greece's initiative and exit from the eurozone would require quick and extensive planning for their effective implementation and the confidence on the part of government that this is the right policy to pursue for the country. The current government could not pursue such a policy since its members clearly do not have that kind of belief or orientation. A coalition government that has broad support and could include political figures from the right to the left as well as some personalities of wide acceptance could best be suited to thread through the difficult path that would lie ahead. Such a government could mobilize the population to accept the sacrifices that will be necessary in the short run and medium run since it would offer an alternative on which the government and its people at least would have a say about the outcome. As a bonus, it could even achieve the fundamental changes in governance that almost everybody has been calling for in Greece but which the existing, currently disintegrating, political system could not deliver.

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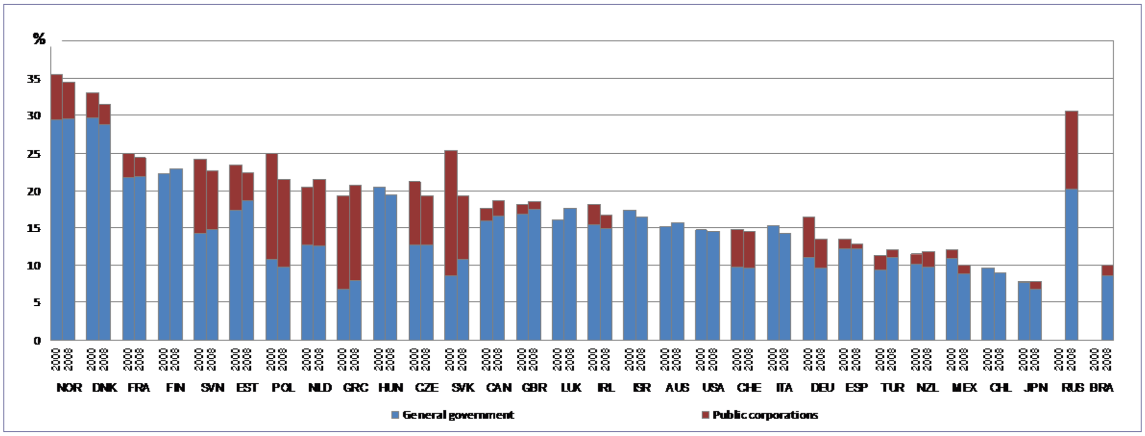

Figure 1: Employment in general government and public corporations as a percentage of the labour force (2000 and 2008). Red bars represent employment in public corporations.
This is Figure 21.2 in OECD (2011).
Source: International Labour Organization (ILO), LABORSTA database. Data for Turkey are from the Ministry of Finance and the Turkish Statistical Institute. Data for Japan for employment are from the Establishment and Enterprise Census. Data for Korea were provided by government officials.
Japan: Employment is not classified according to SNA definition and are substituted by direct employment by central or sub-central governments.
Data for Iceland are missing.
Data for 2000 for Korea are missing and this country is not included in the average (OECD32).
Data for Australia, Chile and United States refer to the public sector (general government and public corporations)
Data for Austria, Czech Republic, Italy, Netherlands New Zealand and Poland are expressed in full-time equivalents (FTEs). In New Zealand FTEs are included for education, health and community services and personal and other services.
Finland, Israel, Mexico, Poland and Sweden: 2007 instead of 2008.
France, Japan, New Zealand and Portugal: 2006 instead of 2008.
Russian Federation; 2005 instead of 2008; Brazil and South Africa 2003 instead of 2008.