The present Greece crisis in perspective

Nilanjan Banik, July 29, 2015, 0 Comments

Mr Alexis Tsipras, Prime Minister of Greece is a worried man. His country's inability to pay IMF Euro 1.5 billion means Greece is on the verge of being denied billion of Euros worth of future loan which perhaps can save Greece from the impending financial crisis, but at the expense of following austerity measures. However, if he has to follow austerity measures such as cutting the budgetary allocation for pensions, raising domestic tax, and reforming labour laws, then he would be seen as a man reneging on his promises on the basis of which he won the election.

In fact, voters in most part of Europe do not like reforms (mainly in the areas of pensions, labours and immigration), and would rather punish the parties in favour of austerity measures. The unfortunate part is, elsewhere in Europe be it United Kingdom, France, Spain, or Greece, where economic crisis is still a central part, people may have to pay a price for being myopic, and not being able to appreciate the long-term gains that may be forthcoming from institutional reforms. Because of economic crisis in Greece, there is a general sense of pessimism about future earning prospects. +

In order to understand this crisis, we have to step a little back into history. Soon after the Second World War, when Europe was devastated, policymakers in the region wanted to re-build Europe on the premise of socialist capitalism. The underlying idea is that when the market is at a nascent stage, the state will ensure that a labour market comes into play and jobs become available. For the elderly, and those without jobs, the state will take care through a benevolent social security system — paying unemployment benefit and pensions. +

The objective is noble, but to make the system efficient the government has to ensure that it collects funds through taxation to pay dole for the unemployed and pension for the retired. Dole and pension are expenditures for the government, and to pay for it, the government has to collect taxes.The principal source of tax is corporate income tax (contributing to nearly 80 per cent of the total tax collection), indirect tax (such as excise and service tax) and direct income tax (that is, taxing the working class). +

At the time of recession when businesses are not forthcoming, or when people find it hard to get a job, it is quite natural that tax collection will be inadequate. Therefore, the government will meet its welfare objective (that is, to pay for dole and pensions) by printing money or by borrowing. Both are perfect recipes for increasing the budget deficit and the public debt. +

A higher budget deficit can be sustained, provided the economy is growing. However, economic growth is continuously falling in the Euro Zone — 3.4 per cent during the 1970s, 2.4 per cent during the 1980s, 2.2 per cent during the 90s, and around 1 per cent between 2001 and 2013.

A reason for this is lack of institutional reforms. In a socialist capitalist structure, wages are protected by trade unions. This is irrespective of labour productivity and firms' ability to earn profit. Add to this, is Europe's ageing population, which is likely to increase further in the future. To maintain a stable population, 2.1 children should be born to each woman in an economy, assuming an average death rate applicable to the world's population.

In contrast, the figures for some Euro-Zone economies are much lower: 1.38 for Greece, 1.39 for Spain, 1.41 for Italy and 1.94 for the UK. For Spain and Greece, the over-65-year population will increase from around 17 per cent now to 25 per cent by 2030. The bottomline: Europe has fewer younger people to work, to pay for the expensive welfare programme.

A natural suggestion would be to reform the labour and pension laws (dubbed as austerity measures), and slacken the immigration laws. A closer look at European democracies suggests it is run by the insiders made up of pensioners, trade union leaders, public sector workers and big farmers. The outsiders consisting of small numbers of immigrants, the youth and small private entrepreneurs have little say.

It is a classic case of a socialist democracy in which the insiders are myopic, care too much about present benefits, and are deliberately voting parties to power that support their cause. On the contrary, the outsiders are quite powerless.Even issues such as changes in labour immigration laws are stalled. A flexible labour immigration clause is expected to resolve issues related to the dearth of a young skilled labour force. The brain drain from developing countries such as India and China has helped fuel economic growth in the US, but not in Europe.

Lack of austerity measures in the form of institutional reforms is reflected in the form of the ever-increasing debt to GDP ratio. Cumulative public debt as a percentage of GDP for many of the Euro Zone countries is already more than 100 per cent — around 132 per cent for Italy, 177 per cent for Greece, 123 per cent for Ireland, 111 per cent for

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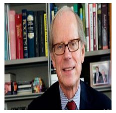
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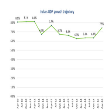
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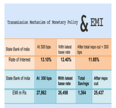
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Cyprus, and 129 per cent for Portugal.

Besides, dissimilar macro-economic conditions (reflected in the debt-GDP ratio) may even threaten the existence of the European Union (EU). This is because it renders a common macro-economic policy — expansionary monetary/fiscal policy during a recession and contractionary monetary/fiscal policy during an expansion — ineffective.

But Europe is diverse, and when Greece is facing recession and Germany is doing well, then following an expansionary monetary policy may help Greece but will heat up the German economy. In fact, as Greece is part of EU, it does not have the autonomy of devaluing its currency, Drachma, and thereby make its exports more competitive.

The only silver lining is the *China* factor. With Greece under firing line, China is likely lose out most. The share of Chinese investment in the troubled European states such as Portugal, Ireland, Italy, Greece and Spain, rose from 10 per cent before 2011 to 30 per cent annually between 2012 and 2014. In fact share of Chinese investment in Europe rose from near zero in 2000 to Euro 14 billion annually in 2014. China can be a knight in shining for Greece.

Tags: China, Greece

About author

Nilanjan Banik is an Associate Professor of Economics and Management at Mahindra Ecole Centrale. Banik works focus on the application of time series econometrics in issues relating to international trade, market structure and development economics ...more

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