Greece and the Eurozone: Background, Context, and Prospects

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Agenda

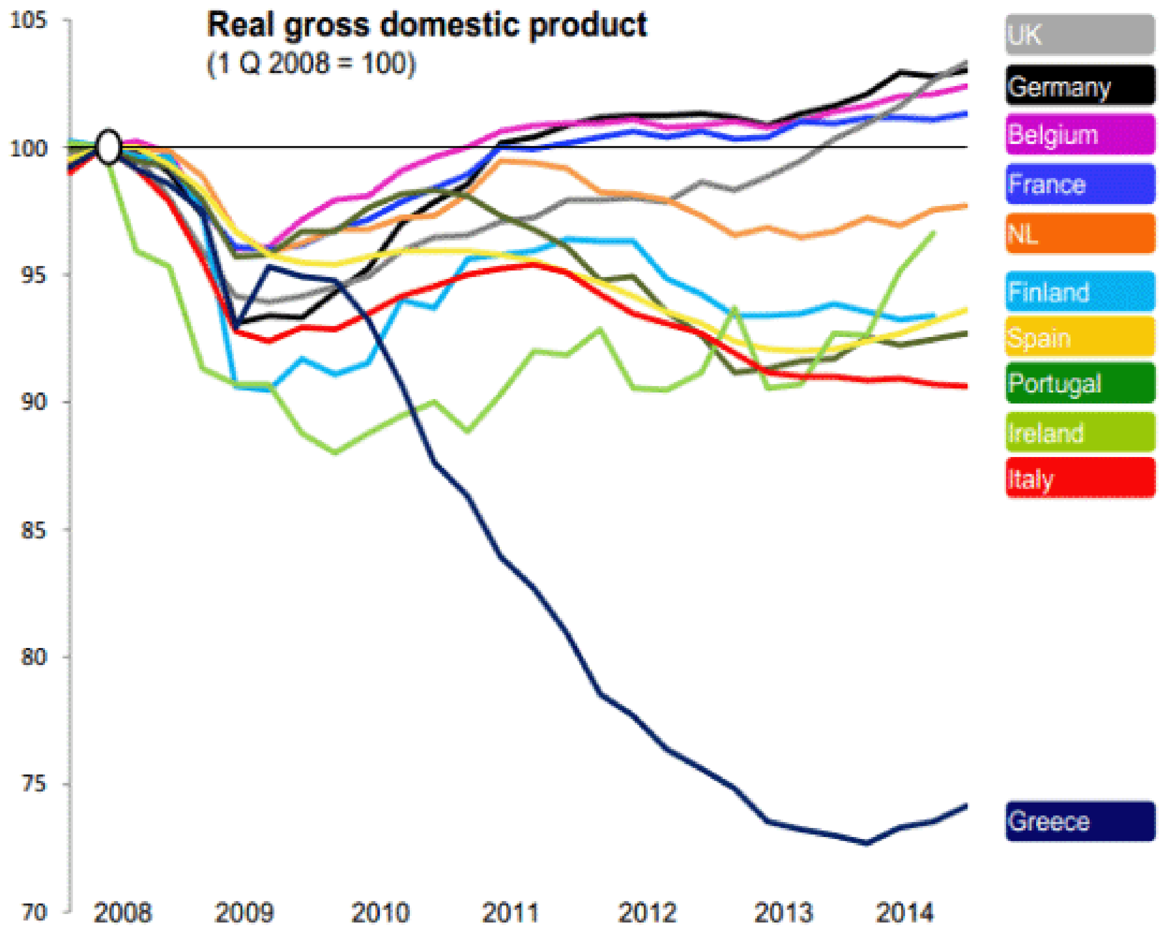
- Background on Greece
- Context: Eurozone and the EU
- Four scenarios: From more-of-the-same to unplanned exit.

Preview: Why is the chance of no compromise high?

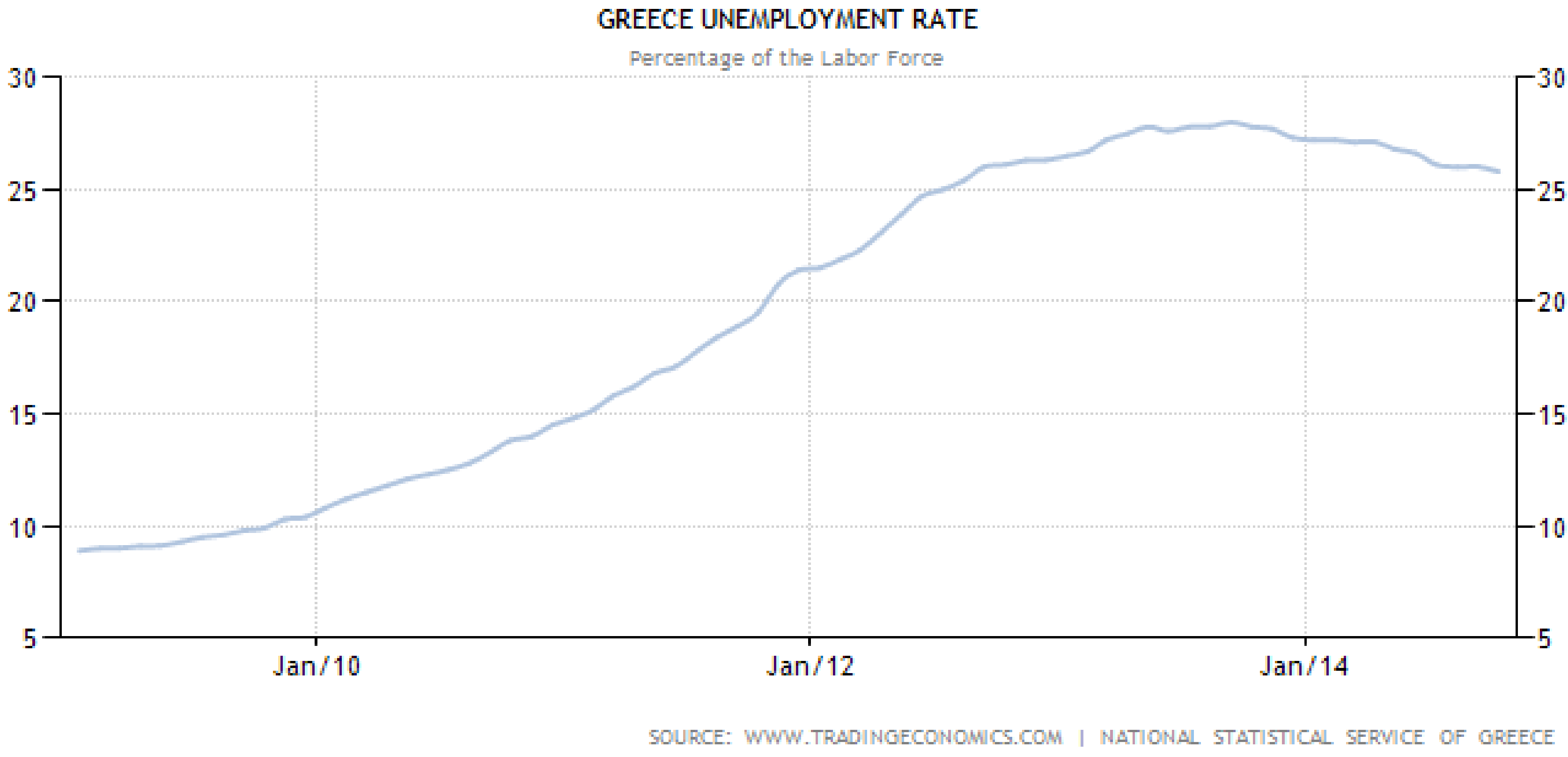
- "Now, the truth is that nobody believes that Greece can fully repay. So why not recognize that reality and reduce the payments to a level that doesn't impose endless suffering? Is the goal to make Greece an example for other borrowers?"

  Paul Krugman, *New York Times,* Jan. 30, 2015
- Second possible reason: Make Greece an example for political reasons?
  - Current EU policy-making regime seemingly all-powerful but losing legitimacy. New Greek government is first serious test; taking a hard line against it could pre-empt future challenges.

GDP levels


Real gross domestic product
(1 Q 2008 = 100)
105
100
95
90
85
80
75
70
2008
2009
2010
2011
2012
2013
2014
UK
Germany
Belgium
France
NL
Finland
Spain
Portugal
Ireland
Italy
Greece

Unemployment Rate



IMF forecasts for Greece and reality

	Real GDP Growth (%)		Unemployment rate (%)	
	IMF Forecast	Actual Outcome	IMF Forecast	Actual Outcome
2010	-4.0	-4.9	11.8	12.6
2011	-2.6	-7.1	14.6	17.7
2012	1.1	-7.0	14.8	24.3
2013	2.1	-4.2	14.3	27.3

Policies and effects

- 27% reduction in GDP (percentage cumulative loss of output greater than US loss during the Great Depression – peak to trough)
- Still more than 25% unemployment rate.
- Highly regressive taxes (VAT tax at 23%, poll tax, penalty for having children, no personal exemptions).
- 28% reduction in public employment; 35% reduction in public wage bill.
- Debt-deflation spiral due to falling wages; now *deflation*.
- A public employee today can hardly afford the consumption basket of one in the late 1950s.

Public Debt to GDP ratio

Why the May 2010 troika agreement?

“It was about protecting German banks, but especially the French banks, from debt write offs.”

Karl Otto Pöhl (former head of the German Central Bank) *Spiegel,* 05/18/2010

2^{nd} agreement of February 2012

- Because 2010 not viable
- Converted bonds under Greek law into debt under English Law.
- Much of the debt reduction fell on Greek pension funds and banks. (Greece borrowed 50 billion euros to recapitalize banks).
- Almost 80% of debt is now official (IMF, ECB, EFSF, and eurozone countries)

Proposed policies of new Greek government

- Confront humanitarian catastrophe and significantly reduce unemployment.
- Bring Greece to a sustainable growth path
- Reduce debt obligations (according to existing plans Greece is supposed to have a primary budget surplus of 4.5% of GDP in 2016 and beyond).

    -Reduction in debt has to be politically feasible.

Make debt payments contingent on growth of GDP?

- At the moment, Greek government was effectively forced to agree to continue the old “troika” program for 4 months but with many internal objections.

Why debt reduction?

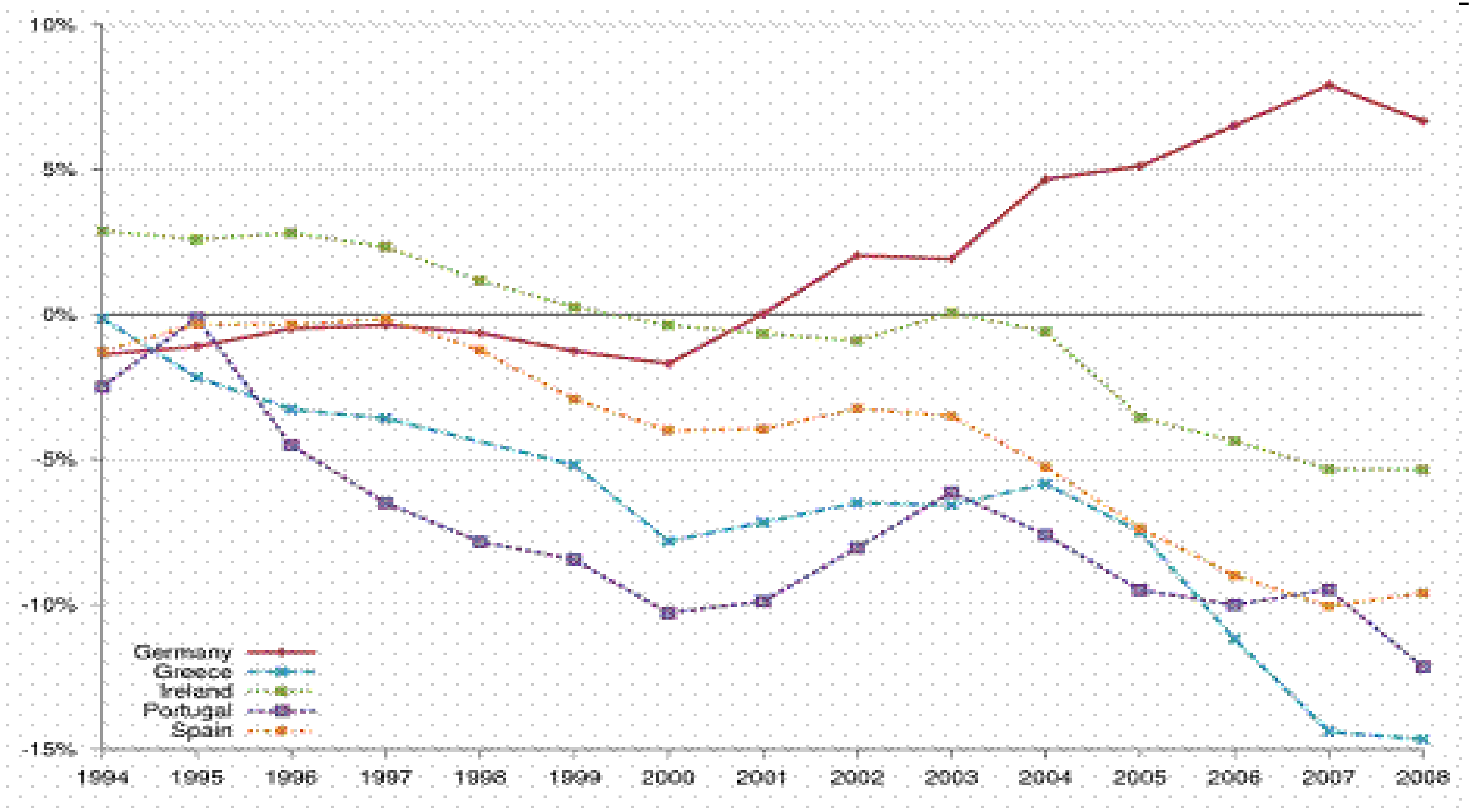
- Unsustainable debt: The more you try to fully pay, the lower your ability to do so.
- (How could mass unemployment help a country pay its debt?)
- Reason for bankruptcy protection for individuals and corporations, and there is no longer debtors' prison.
- What about the responsibility of the borrower to repay?
- What about the responsibility of the lender to lend wisely?
- Versailles agreement vs. Marshall Plan and 1953 debt forgiveness conference for Germany.

Context: Problems with 19 countries sharing one currency (EMU)

- Problematic bank supervision, regulation, and only national deposit insurance.
- Absence of common fiscal policy.
- Absence of policy coordination to remedy current account imbalances.
- Central Bank with limited mandate.
- Limited labor mobility

Current Account Imbalances

(From Lapavitsas et. al., 2010)



EU Decision-making

- Formally, each country has veto power on each decision.
- *De facto,* a small insiders' circle makes all decisions; the rest follow through even in important decisions that may harm their own countries.
- Ostracism an effective counter to the veto; other informal mechanisms.
- Even hints of a challenge can destroy one's career (e.g., elected prime-ministers Papandreou and Berlusconi).

EU Decision-making II

- ECB decision to no longer accept Greek bonds as collateral (Feb 4) an example of tactics used to maintain compliance within EU bodies.
- Insiders tend to “believe their own press” and grow intolerant of different opinions; a club with sometimes an uncertain connection to reality.
- Many do believe austerity is the right policy and all is fundamentally fine with the Eurozone

Policies of Eurozone/EU and political consequences

- Synchronized Austerity
- Market fundamentalism (deregulation, privatization, reduction of social insurance)
- Creditor-friendly policies
- Convergence of traditional conservatives and social democrats/socialists
- Political destruction of the traditional center (because of their gradual adoption of deeply unpopular policies)

Positions of Concerned Parties

- Insiders/Core of Eurozone and EU adamantly opposed to any debt reduction.
- Peripheral governments (e.g., Spain and Portugal) take a similar position.
- Greek government asked for serious debt reduction, but issue no longer on the table (threat to eurozone disintegration but *no threat of unilateral exit*)
- Diffuse support for Greek position, but unorganized and not represented in EU institutions.
- US concern for Eurozone break-up and support for some debt reduction.

Current concerns

- For March, every week Greece has to pay around 400 mil. Euros to the IMF in view of lower tax receipts.
- The ECB and other institutions are maintaining continual pressure.
- As a result, silent bank run (probably) continues.
- Tremendous pressure on government to
  - Fund government obligations.
  - Capitulate to all demands from “institutions” (the old “troika”)

Four scenarios

- More of the same – extend and pretend
- Uncontrolled exit from the eurozone.
- Agreement with sustainable debt within the eurozone.
- Agreement with exit from the eurozone (presumably with sustainable debt).

More of the same

- No essential debt reduction (by, for example, extending maturities of loans)
- Continuing cuts in expenditures and increases in taxes.
- Syriza would likely split, with government supported by (former) two big parties.
- Implications for Eurozone: Wait until the next crisis hits (President Le Pen?).

Uncontrolled Exit from Eurozone

- Due to accident or making Greece and example.
- Very difficult economic adjustment at the beginning (e.g., shortage of imported goods).
- Lehman squared or no problem for the eurozone?

Agreement with sustainable debt within the eurozone

- “Bad” precedent for other peripheral countries?
- Achieved through “GDP growth swaps?”
- What will happen to Italy, Spain, Portugal and, even, France?
- (Long) road towards political unification?

Agreement with exit from the eurozone (presumably with sustainable debt)

- Some planning will reduce the shock of an uncontrolled exit.
- Possible advantage: Debt reduction hidden or more possible within the new drachma.
- Insiders/Core might think getting rid of “bad apple” will improve prospects of eurozone.
- Still, uncertainty about future of eurozone.
- For Greece, scenario that will reduce unemployment fastest.

The Next Three months

- High uncertainty about what will occur.
- Capitulation or exit from eurozone?
- New elections? Referendum?
- If exit, what kind?
- What kind of debt reduction?
  – One euro – one drachma (at least for official debt)?
  – Possibility of debt tied to economic growth?