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The Greek Crisis: Development and Prospects

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The discussion of a Greek exit (Grexit) from the Eurozone is dominating the news once again. Following the victory of Syriza in the Greek election in January this year, economists and policymakers in Europe have been showing growing concerns about the negotiations between the Greek Government and the Troika – the IMF, ECB and European Commission. Greek Prime Minster Alexis Tsipras stated on various occasions in international media that Greece will remain in the Eurozone. However, he also affirmed his commitment to carry out anti-austerity electoral promises, which are not in accord with the bail-out program set up by international creditors. This is a tought two-level game in which the government must reflect domestic concerns expressed through the election while also satisfying international commitments. In this context, the possible development toward a Grexit creates political and economic uncertainty in Europe.

Greece has been experiencing a record-breaking economic recession since late 2008. Its GDP fell under less than 75% of the pre-crisis level, and unemployment rate soared over 25%, the highest figure in Europe. This severe recession can mainly be attributed to deleveraging in both public and private sectors during the structural adjustment of the Greek economy after the debt crisis in 2010. The Greek government has reduced its spending dramatically since 2010, and executed a number of reform measures in order to improve fiscal sustainability. Its fiscal deficit has been considerably reduced from 10% of its GDP in 2010-11 to 3.5% in 2014. However, the austerity measures have brought about further economic depression in the context of a sudden drop in foreign financing. Supported by a wide range of wage cuts, its external sector seemed to improve; its current account deficit shrunk considerably. However, a so-called ‘internal devaluation’ was ignited by the compression of internal demand and deteriorating labor market conditions. The country’s massive current account improvement since 2010 was almost exclusively due to a cut in imports, caused by the compression of domestic demand, while exports increased by only a very moderate degree. The Greek economy is faced with an extremely fragile situation, and the economy has yet to show signs of recovery.

In this context, it has been increasingly questioned whether Greek public finance is sustainable for the coming years. The public debt to GDP ratio of Greece is almost 180%. While public deficit has been reduced and primary balance has almost balanced out, the public debt level does not fall in the context of sluggish economic growth. Compared to the period of 2011-12 when a Grexit was first evoked as a serious matter, the public debt structure of Greece has undergone noticeable changes. The debt share of private holders shrank considerably through the debt haircut, while the share of international public institutions, such as the IMF, ECB and EFSF, increased. Currently, almost 80% of Greek public debt is held by these non-Greek public institutions. With the deadline for reimbursing international loans looming, particularly that of the IMF, repayment appears to be the most urgent issue at hand. Next July and August will be critical months for both the Greek government and the Troika, because massive Greek bonds will be due for maturity. In order to roll over these bonds, it is necessary to secure the next tranche of bailout funds or another bailout. Otherwise, the Greek government will face a technical default situation.

The Greek government set up, jointly with the Troika, a target of reducing its debt to GDP ratio to 120% by 2020. This target seems unrealistic considering the current economic situation in Greece. In order to meet the target, the government will have to maintain a fiscal surplus in its primary balance by 6~9 percentage points (of GDP) every year. However, there is no precedent among OECD countries of a fiscal surplus of this size over an extended period. This suggests there will be a serious debate on the Greek debt haircut in the coming years.

At this moment, it is difficult to forecast how the Greek crisis will develop. Will Greece stay within the Eurozone in two years, or leave behind a first precedent of exit from the Eurozone? The answer depends more on political factors than on economic ones. However, it is noteworthy to expect the following four possible scenarios.

Scenario 1. Stay in the Eurozone with additional support (from the Eurozone)

The Eurozone (possibly with the IMF) agrees to provide another bail-out fund, *albeit* small, while the Greek government accepts a less demanding bail-out program in exchange for a reaffirmation of its previous commitment. This scenario is the most ‘smooth’ outcome resulting from a political compromise, while the sustainability of public debt in the future still remains a question.

Scenario 2. Technical default of Greece in the Eurozone

If the Troika chooses not to provide the next tranche of bail-out funds amid disagreement with the Greek government, it is likely that the Greek government will not meet its repayment obligations to international creditors. In this situation, Greece will face a technical default, which it already experienced in 2011 during its debt haircut process. From this point, the situation will develop either on to Scenario 1 (stay in the Eurozone) or Scenario 3 (capital controls), depending on subsequent Greece-Troika negotiations.

Scenario 3. Capital controls with Eurozone membership

If no compromise is reached in 3-6 months, it is likely that capital controls will be introduced to limit bank-run and money outflow. This mimics the case of Cyprus in March 2013. In this situation, Greece would be not considered as a full Eurozone member, although it still remains in the Eurozone from a legal point of view. If this situation is sustained for an extended period of time, the Greek financial sectors will be severely damaged and lose trust from international investors.

Scenario 4. Exit from the Eurozone

This would happen, if the Greek government and the Troika fail to reach a compromise due to strongly divergent point of views and Greek banks are cut off from ECB funding. In this situation, the Greek government would not meet its financial needs in the current euro system and would instead begin to print its own money.

At the very moment this article is being written, it is quite clear that both the Greek government and the Troika are seeking to realize the first scenario. However, negotiations between Greece and its creditors in Brussels are proving to be a classic game of chicken, and are creating uncertainties. Furthermore, the Greek case will leave behind a precedent for dealing with debt crisis in the Eurozone. If the Eurozone does not tackle this case properly, it could be regarded as a rupture of the currency union and could bring about contagion across other fragile countries.

How does the Greek crisis affect the European economies? Currently, most of Greek's government debt is held by international public institutions and the share held by European banks is small. The ECB completed its review on commercial banks' asset quality in late 2014, and most banks have already prepared a financial buffer for their exposure to Greek debts. This suggests that Greek crisis will be less likely to cause financial turmoil in the European banking sector than before. The ECB's strong commitment to dealing with the crisis and the large volume of quantitative easing (QE) underway would also work toward a positive outcome. However, the consequence of the Greek crisis is still unpredictable, and this may start a domino effect in other countries, which could destabilize an entire currency union. From Korea's point of view, it is important that ripple effects of the Greek crisis are minimized and European economies continue to recover. Considering the trade and financial linkage between Korea and Europe, more robust growth of European economies would work in favor of Korea's export to Europe, as it did in mid-2000s.