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# No Painless Solution to Greece's Debt Crisis

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## Key Points

- Greece currently faces a crisis on two fronts: there has been a long-run build-up of public sector debt due to persistently high budget deficits, and a very rapid build up of excessive external debt due to several years of massive current account deficits. Greece has been living beyond its means and must immediately cut spending and imports to check its unsustainable deficits.

- The government went into the global crisis with an already high budget deficit and public sector debt above 100% of GDP, much of which is held by EU banks. The global crisis compounded the problem as the government sought to boost growth rather than prioritising fiscal prudence - hiding the overshoot in the budget until late 2009.

- Whether Greece adopts austerity measures or has austerity imposed by financial market turmoil, there is little option but to cut the twin deficits rapidly, implying a steep recession and drop in imports. Achieving both growth and fiscal consolidation seems highly unlikely - growth will have to give way.

- Close monitoring of progress by the European Commission should provide the credibility Greece needs to meet its financing requirements through the market (at least this year) but if Greece still fails to control its runaway finances, it will have no choice but to seek a bailout.

- The most drastic solution - abandoning the euro as a prelude to devaluation - would not change the requirement to cut the twin deficits since short-term export competitiveness is not the key issue and opportunities to boost exports (including tourism) are quite limited, especially as the European economy remains weak. Those who see euro exit as attractive should also recall the instability generated by historic episodes of devaluation.

## Background to Greece's debt crisis: multiple errors build up

Until October 2009, it appeared that Greece had weathered the global crisis relatively well according to the official figures available at the time. Estimates pointed towards a contraction of less than 1% of GDP and public finances, while never strong, seemed relatively stable especially compared to the rapidly escalating deficits expected in countries with major bank bailouts and fiscal stimulus packages (such as the US and UK). In October 2009, on the eve of the election that ushered in the new Socialist government, the reported deficit for the year officially stood at 5.1%, similar to the EU average predicted at the time (although the outcome for the EU has also deteriorated and is now expected to be more like 6-7%). This temporarily dispelled the European Commission's frustration with the persistently high historic deficits run by the Greek government even after the adoption of the EU Growth and Stability Pact in 1997. Since 1997, Greece has only met the minimum deficit target of 3%[1] in one year, and the debt-to-GDP ratio has hovered at around 100% throughout the decade despite Greece's relatively fast growth during the period (the ratio is currently among the highest in the world, and is only comparable to Italy's among EU members).

**Table 1: Greece's macroeconomic performance since the 1980s**

| (annual average) | 1980s | 1990s | 2000s |
|---|---|---|---|
| Real GDP growth (%) | 0.8 | 1.9 | 3.6 |
| Government balance (% of GDP) | -8.1 | -8.5 | -4.9 |
| Current account balance (% of GDP) | -3.9 | -2.5 | -9.1 |
| Annual Inflation (%) | 19.5 | 11.0 | 3.4 |
| Exchange rate (% change vs. USD )* | -281 | -93 | +35 |

* % change over the decade, negative sign indicates devaluation

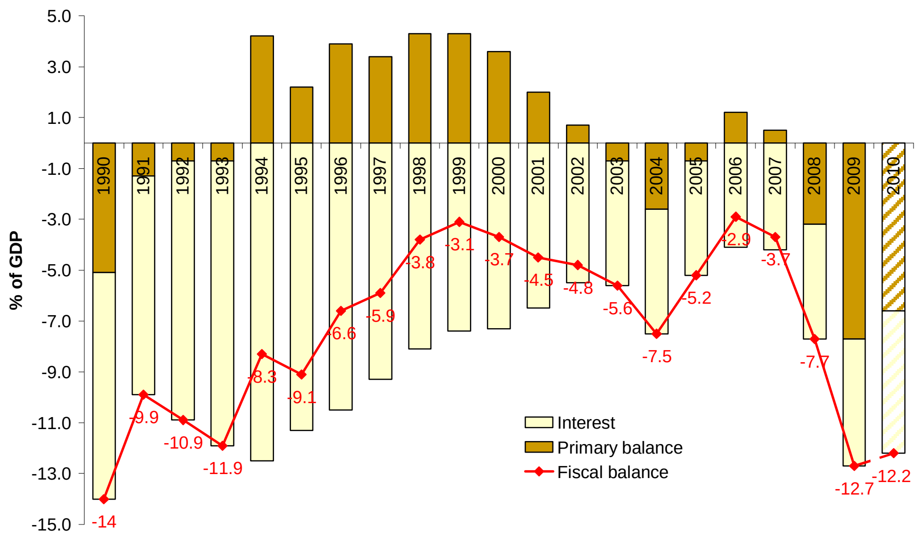
*Source: IMF*

Partly thanks to euro membership and access to lower interest rates, some degree of budgetary discipline and debt stabilisation was achieved towards the end of the 1990s, particularly compared with the 1980s and early 1990s when interest payments accounted for the bulk of the government's deficit. However, there has been a chronic difficulty in financing this deficit due to the low level of domestic savings: since 1990, the national savings rate has

[1] Portugal has missed the deficit mark six times in the ten years after 1997, Italy five times, and Spain only twice

averaged just 11% (the average for Portugal, Italy and Spain has been slightly over 20% during this period)[2]. Thus much of the funding has been raised externally, resulting in a high proportion of Greek debt being held abroad. Currently over 80% of Greek government debt is external rather than domestic, amounting to €224 billion according to official sources, much of which is held by foreign banks (mainly European).[3]

**Figure 1: Greece's budget deficit history shows only short periods of improvement**




*Source: European Commission*

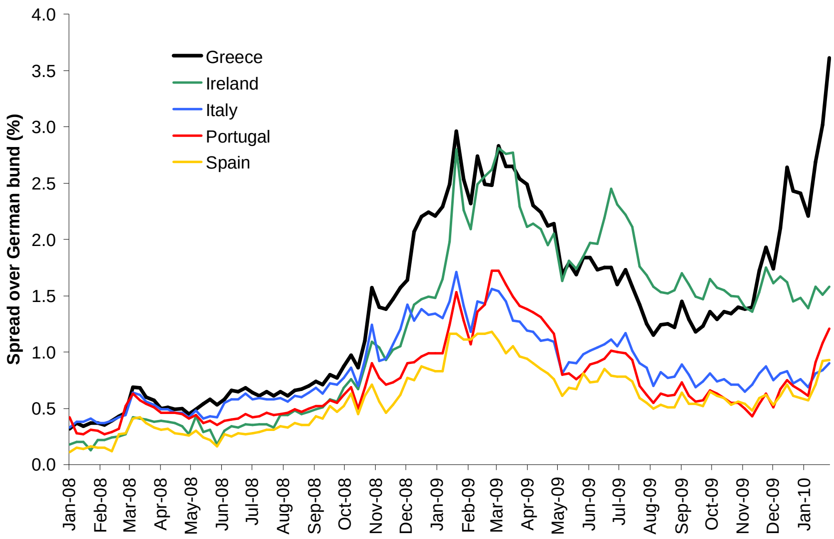
Additionally, there has been a problem of misreporting of statistics by the Greek authorities. Greek debt and deficit figures were understated in order for Greece to become a member of the European Monetary Union, and a similar story seems to have occurred with the figures for 2008 and 2009 possibly being massaged ahead of the impending election. Although most countries have seen estimates for their budget deficit swell over the course of 2009 (the UK's estimates, for example, went from about 7% to over 12% of GDP), the magnitude of the Greek revisions over both 2008 and 2009, and the implications for already excessive external debt financing, has been shocking. The estimated 2009 deficit rose from 5.1% for 2009, as reported to the EC

[2] Household savings rates are even lower, estimated at around 6-7% although official figures are not reported to the EU - Greece is the largest Euro area country not to do so

[3] According to BIS statistics, foreign claims on Greece amount to \$302.6 billion of which \$106.8 billion is claimed on the public sector. At 31.6% of GDP, this is over twice as large as the average of the other PIIGS (15.1%).

during the spring, to 12.7% by the late autumn while the 2008 deficit was corrected from 5.2% to 7.7%. By themselves, these figures would have been alarming – after all the surge in the US and UK's public deficit into the double digits has aroused concern over the possible loss of their sovereign AAA rating as well as causing an outcry over the public sector's growing liabilities. Greece's poor track record and the limited room for manoeuvre afforded by its existing level of debt have only increased the risk factor – and Greece has served to spread the risk to other weak and indebted euro area economies such as Portugal, Italy and Spain.

**Figure 2: Credit spreads over German bund**




*Source: Financial Times*

Together with Greece, these countries have been given the rather unflattering acronym of PIGS (or PIIGS if both Ireland and Italy are included), now synonymous with economies facing significant financing constraints as well as a poor track record of fiscal discipline. Unsurprisingly, the market reaction to Greece's debt dilemma has caused some degree of collateral damage to these other economies, especially given the fear that a worsening Greek situation could lead to major fiscal crises among the other PIIGS. But although the PIIGS share many of Greece's particular vulnerabilities, no other country shares them all to the same degree (Portugal comes closest). Alone among the PIIGS, Greece finds itself in the unique situation of suffering from twin deficits (that is, both a budget deficit on the fiscal side and an external current account deficit provoking a balance of payments crisis), twin debt problems (a large debt stock which is mostly external), critically low savings and a high volume of debt due in the near term.

**Table 2: Comparison of government debt risk**

| | Budget deficit 2010 (% GDP) | Debt-to-GDP 2010 | External debt (% debt) | Short-term debt* (% GDP) | Current account 2010 (% GDP) |
|---|---|---|---|---|---|
| **Greece** | -12.2 | 124.9 | 77.5 | 20.8 | -10.0 |
| **Portugal** | -8.0 | 84.6 | 73.8 | 22.6 | -9.9 |
| **Ireland** | -14.7 | 82.6 | 57.2 | 47.3 | -1.7 |
| **Italy** | -5.3 | 116.7 | 49.0 | 5.7 | -2.5 |
| **Spain** | -10.1 | 66.3 | 37.0 | 5.8 | -6.0 |
| **UK** | -12.9 | 80.3 | 22.1 | 3.3 | -2.0 |
| **US** | -12.5 | 93.6 | 26.4 | 8.3 | -2.6 |

* Includes debt from monetary authorities due in one year or less

*Sources: European Commission, World Bank, IMF*

## Coping with twin deficits and other constraints

Countries running persistent fiscal and current account deficits face a much more difficult process of macroeconomic readjustment as low domestic savings rates require these deficits to be financed from abroad - and this is even harder when global capital flows dry up. Greece had seen a rapid deterioration of its persistent current account deficit, which reached double digits after 2006 and was actually the third largest in the euro area in absolute terms despite the relatively small size of the Greek economy.[4] Most of this deficit was due to rapid growth in consumer demand and thus the volume of manufacture imports – in fact, exports did well until the global crisis hit trade everywhere. However, for some analysts, the trade deficit is seen as a legacy of a longstanding inability to compete in manufacturing and the small industrial base[5], which accounted for only 11.8% of GDP in 2007 (a much

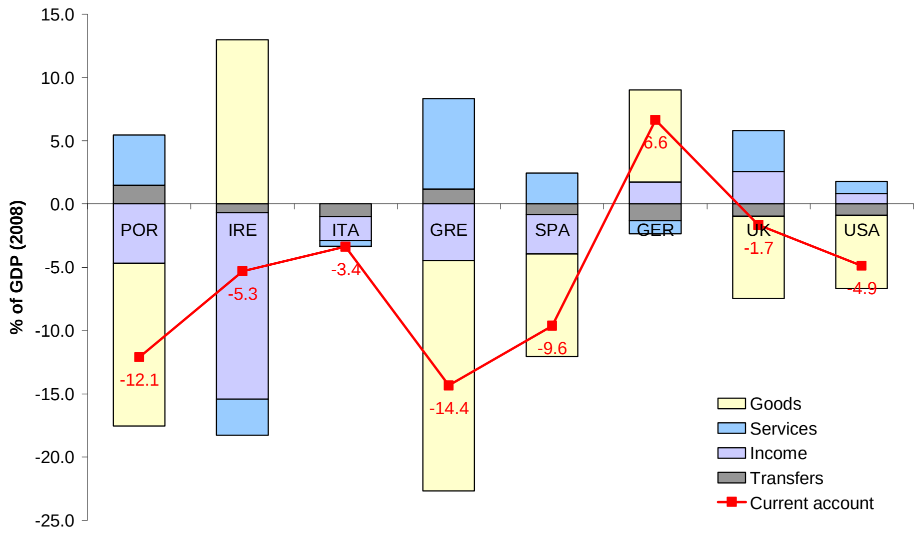
[4] The Greek current account deficit stood at $51.5 billion in 2008. Italy's deficit was $73.2 billion and Spain's was $154 billion.

[5] Concerns over Greek competitiveness are hardly a new story: a 1992 paper by Takis Fotopoulous largely echoes many of the difficulties facing the Greek economy today, making note of the country's excessive reliance on services and its imbalanced demand pattern (consumption growing faster than GDP and production) which could only be met through rising imports.

lower share than other industrialised EU economies). Certainly, unless Greece can increase export revenues, then demand and GDP growth will be constrained by the balance of payments and limits to rising external debt.

High local spending versus low domestic savings also led to resident banks seeking financing from abroad, including the use of emergency ECB funding to fill the void once the onset of the credit crunch disrupted access to foreign capital markets. So the private sector added to the external debt problem.

**Figure 3: Current account balances of PIIGS versus Germany, UK, US**




*Source: IMF BOPS*

The existence of twin deficits is not limited to Greece: Portugal and Spain are also facing the problem of having to consolidate their fiscal position and stabilize current account imbalances. As these countries are all locked into EMU, they have no option to devalue, which may offer a quick way of boosting net trade for countries with price sensitive export sectors (such as the UK). Instead, adjustment is typically seen as requiring wage and price cuts to boost cost competitiveness and net trade and, over the long run, it is important to review structural improvements of skills and industries in order to encourage export performance.

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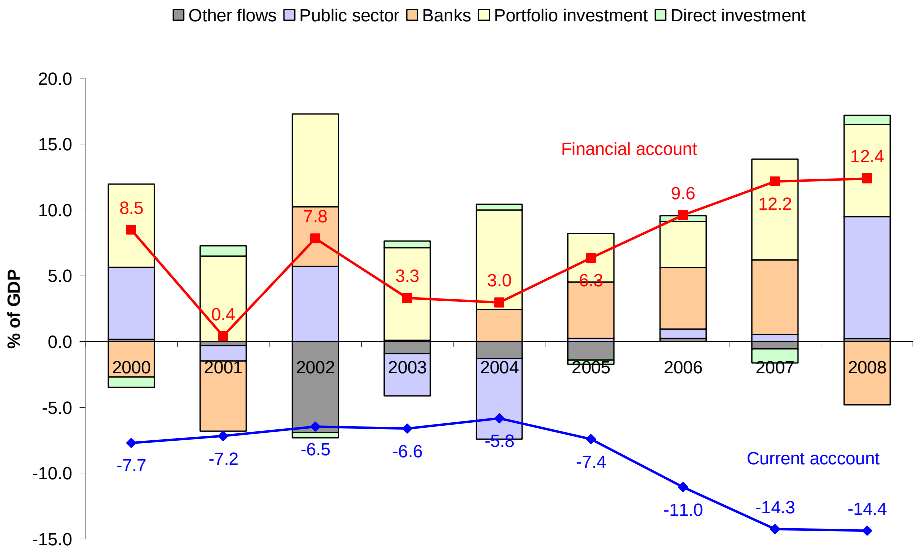
Fotopoulous, T. (1992), Economic restructuring and the debt problem: the Greek case. *International Review of Applied Economics*, 6 (1).

**Figure 4: Financing the Greek balance of payments since 2000**




Note: Public sector includes government and monetary authorities

*Source: IMF BOPS*

The situation is exacerbated by the existence of a trading powerhouse like Germany within the EMU, which not only competes through its historic advantages in skills and technology but also through aggressive wage repression.[6] It is therefore difficult to imagine how EMU economies with large external deficits can resolve such deficits without undergoing deep recessions in the short-run - in order to curb deficits in the future they may face the prospect of sluggish growth lasting well into the next decade. This is a constraint on growth that can only be relaxed if export performance is permanently improved.

Nevertheless, achieving fiscal stability and reducing the external deficit, even at the expense of growth, can at the very least dispel market fears of a sovereign debt crisis and its consequential spillover risks. Unfortunately for Greece, twin deficits are not the only problem.

Its enormous public sector debt stock (projected to be 124.9% of GDP in 2010, exceeding that of Italy) is primarily external, rather than domestic, making the process of refinancing (and renegotiating if needs be) a complicated cross-border process. Financing is an immediate challenge as a large share of this debt will be due in 2010: an estimated €53.0 billion needs

[6] Calculations from DIW-Berlin and official sources have shown that real wages in Germany remained flat between 2000 and 2008 and in fact decreased -0.8% annually from 2004 onward.

to be raised, of which €25.2 billion is due between April and May alone.[7] The ability of the Greek government to finance these short-term obligations is as yet unclear. A €5 billion public bond issue in January was considerably oversubscribed despite the fact that it originally carried a 3.75% premium over the risk-free rate (an increase of 250 basis points from an earlier issuance in March 2009) - this prompted the issuance to increase to €8 billion at a lower premium of 3.5%. But subsequent sales of debt will likely be met with yet higher rates as the uncertainty over a bailout or a default has increased, damaging the country's sovereign credit ratings.

**Table 3: Greece's short-term financing needs (as of 31 Jan, 2010)**

| | |
|---|---|
| **January 2010 bond issue:** | € 8 bn<br>5-year paper<br>3.5% premium over risk-free rate |
| **Gov't refinancing requirement April-May** | € 25.2 bn |
| **Gov't refinancing requirement 2010** | € 53.0 bn |
| **Gov't debt stock** | € 270.8 bn (2009)<br>€ 303.8 bn (2010) |
| **Gov't debt stock held abroad** | € 223.6 bn (Q3-09) |
| **Credit rating (outlook)** | S&P, Fitch: BBB+ (-)<br>Moody's: A2 (-) |
| **Projected current account deficit** | € 19.2 bn (2010)<br>€ 19.3 bn (2011) |

*Sources: Deutsche Bank, Wall Street Journal, European Commission, Bank of Greece, BIS*

**Box 1: Local politics and the threat of social unrest**

Greek politics have been relatively stable since the restoration of democracy in 1974 after decades of military rule. The socialist party known as PASOK has dominated government since it first won the national elections in 1981, save for two brief spells during 1990-93 and 2004-09 in which the conservative New Democracy (ND) party was in power. Until 2004, PASOK rule over nearly a quarter of a century prompted a period of modernization which culminated in the induction of Greece into the EMU in 2001 (it had originally missed the Maastricht criteria for entry in 1999) and the convergence of economic and living standards towards the EU average. Still, it was only until the last decade in which growth picked up rapidly - performance during the 1980s was mediocre and highly volatile as the country struggled through the second oil crisis, leading to a three-year

[7] Deutsche Bank (2010), "Greece: Financing risks", *Focus Europe*, 15 Jan 2010.

recession during 1981-83. Growth was less than half the EU average over the course of the decade and inflation was over twice as high.

But despite the fact that there has been no violent regime change during Greece's modern democratic period, local politics have been characteristically turbulent at times, including numerous political scandals and foreign affairs disputes. PASOK was characterized by highly populist policies (including excessive capital expenditure and onerous benefits to public sector employees) which had the effect of incurring large deficits and inflation. Unsurprisingly, the national debt skyrocketed: from 25% of GDP when PASOK took the reins in 1981 to 71% in 1990 - nearly triple in less than a decade. And from 1993 onwards it has remained steady at around 100%. Unsurprisingly, despite the mismanagement of Greece's public finances by ND in its latest stint in government, the legacy of high public spending by PASOK has been difficult to dispel and is certainly one of the reasons why PASOK has not been able to muster enough market confidence in its reform agenda even when it has tried to claim that the spiralling deficit problem and the issue on misreported statistics has been an inheritance from ND (not entirely true given that the government previously lied to achieve the Maastricht criteria).

Domestically, however, PASOK does enjoy a comfortable margin over the opposition. Its absolute majority in parliament (160 seats out of 300) ensures that legislation can pass easily, and the re-election of the President can eliminate the threat of elections and further delays in policy decisions. Recent polls further suggest that the government is on steady ground: PASOK retains more popular support than the opposition (39.6% to 29% as of late January)[8], and 58% of Greeks approve of the government's handling of the economy. Nor is there any sentiment which suggests the country should turn its back on the EU: 69% of Greeks agree that EU rules should guide economic policy.[9]

But if the government fails to meet its growth targets, public sentiment could quickly change. In recent weeks there have been massive farmers' protests against the government's austerity plans - these have been supported by the Greek Communist party which happens to be the third largest political force in parliament. That these protests are focused on the loss of subsidies to compensate low commodity prices goes on to show the economy's sheer level of dependence on public handouts. And memory of the riots which rocked Athens and other major Greek cities in December of 2008 is still fresh

[8] MARC poll, 21 January 2010
[9] BNP Paribas *Daily Economic Spotlight*, 21 January 2010

in the minds of those who fear a similar relapse into social unrest. Given Greece's notoriously rigid labour market and history of state patrimony, any surge in unemployment, dismantling of state benefits or wage cuts could trigger a social backlash which the opposition could no doubt use for political gain - and which would further undermine confidence in the ability of the Greek government to survive any imposed austerity plan unscathed.

## Fiscal stability in the European Union

Maintaining stable fiscal deficits and debt levels has been a requirement for member states of the European Union since the signing of the Stability and Growth Pact in 1997. Although revision to the pact allowed for some leeway in terms of cyclical deficits, EU governments are required to maintain a budget deficit which does not exceed 3% of GDP, as well as a debt-to-GDP ratio of 60% at the most (additional inflation, exchange rate and interest rate targets are set for potential adopters of the euro). If the European Council decides that any given member state is breaking these targets and takes no action to rectify this within 16 months of the decision, sanctions can be imposed. These sanctions come in the form of a non-interest-bearing deposit within the Community which comprises a fixed component equal to 0.2% of GDP and a variable component equal to 1/10 of the difference between the deficit as a percentage of GDP in the year in which the deficit was deemed to be excessive and the reference value of 3% of GDP.

Nevertheless, the Stability and Growth Pact has not previously been well enforced. For example, punitive measures were started against Portugal in 2002 and Greece in 2005 (although there were no sanctions), but not against France and Germany whose debt-to-GDP ratios had breached the 60% earlier in the decade. In 2005 the pact was reformed to be more flexible by accommodating cyclical adjustments - these became ultimately necessary after the crisis exploded in 2008 and most EU countries exceeded the deficit and/or debt targets, often by a considerable margin[10]. Nevertheless, the European Commission in November 2009 set targets for the correction of budget deficits in various member states, stretching to 2012-13 depending on current levels. A few of the most critical countries - Greece, Spain, France,

[10] EU average deficits in 2009 were -6.9% compared to -2.3% in 2008. The debt-to-GDP ratio for the region stood at 73%, an increase of 12.5% from one year earlier.

Ireland and the UK - were further scrutinized and given later timeframes for compliance (in the UK's case as late as 2014/15) but it was concluded that Greece had not taken "effective action" to address its budgetary position, noting higher-than-budgeted capital spending and public worker compensation as well as the massive jump in the deficit reported by the newly sworn-in government.

The Greek government was therefore hard pressed to come up with a convincing programme for fiscal restructuring, one which would both satisfy the European Commission's targets and appease the markets. This came in the form of Greece's Stability and Growth Programme set out in mid-January. It proposes to cut the budget deficit below 3% by 2012 through reduced spending on public sector workers, defence and healthcare, as well as increased tax collection, the latter being seen as a long overdue reform given the constant criticisms of Greece's high levels of tax evasion and fiscal opacity. An overhaul of the national statistical service was also promised, prompted by the lack of accuracy in its earlier reporting. Furthermore, despite forecasting a -0.3% drop in GDP for 2010, growth was expected to pick up afterward, reaching 2.5% in 2013. After examining these ambitious targets, financial markets reacted negatively based on the implausibility of achieving both the tough fiscal target and the forecast rate of GDP growth target as well as the lack of clarity over where spending would be reduced after 2010.

**Table 4: Comparison of growth and fiscal projections**

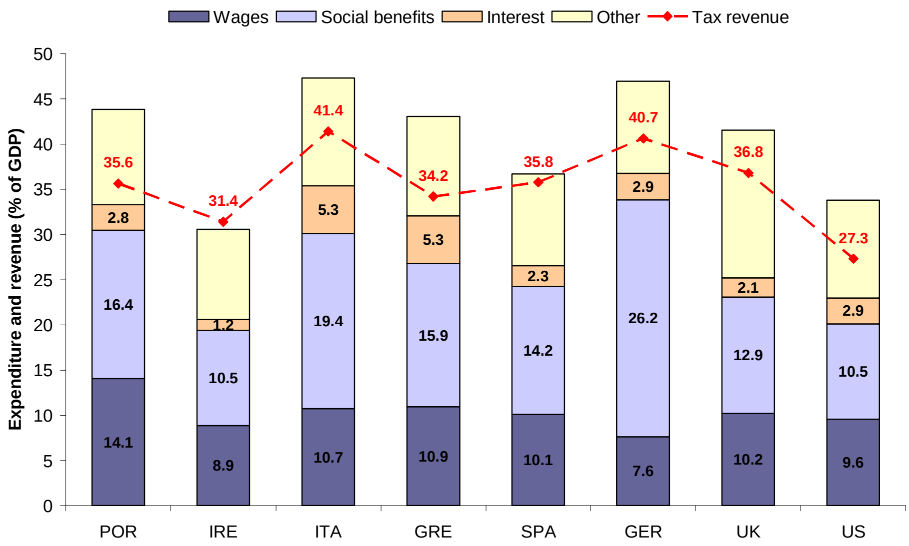
| **Greek plan** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|
| Real GDP growth (%) | -0.3 | 1.5 | 1.9 | 2.5 |
| Budget deficit (% of GDP) | -8.7 | -5.6 | -2.8 | -2.0 |

| **EC/IMF forecast** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|
| Real GDP growth (%) | -0.3 | 0.7 | 1.1 | 1.6 |
| Budget deficit (% of GDP) | -12.2 | -12.8 | | |

*Source: BNP Paribas, European Commission, IMF*

Despite the criticism of Greece's tax revenue, it is only slightly lower than the OECD average in Europe - 32.2% against 37.8% of GDP. Nevertheless, there is some scope for catch-up in areas such as taxes on income, profits and capital which represent less than a quarter of total tax revenue, compared to around one-third in OECD Europe. Likewise, the suggestion that the public wage bill in Greece is overblown is not entirely correct: public expenditure on wages is not significantly higher than the other PIIGS or even some of the larger EU economies like Germany and the UK. Rather, concern over wages - both public and private - has been focused on their high growth during the decade,[11] as well as the rigidity and centralisation of the labour market which prevents a natural adjustment with productivity rates within sectors.[12]

**Figure: Comparison of expenditure and tax revenue (2000-07 average)**




Note: Tax revenue includes social contributions. Figures may vary slightly from OECD data

*Source: IMF GFS*

## Possibilities for bailout and default

Should Greece be unable to meet its financing commitments, the most likely course of action will be to accept a bailout or declare itself in default, which is highly unlikely unless there is a very short-term technical issue in the market.

But the possibility of a bailout must also consider the question of who would come to the rescue, the obvious candidates being either the EU or the IMF, which has already helped over a dozen of the hardest hit economies over the course of the previous two years. In fact, the IMF seems the logical choice, given that it has the mandate to assist countries in need, and has expressed the willingness to do so.[13] Already the IMF has provided stand-by

[11] According to Eurostat, Greek nominal unit labour costs increased by 24.7% between 2000-08 whereas in the Euro area they rose 15.5% during the same period.
[12] Moschovis, G. and Capo Servera, M. (2009), "External imbalances of the Greek economy: the role of fiscal and structural policies", *ECFIN Country Focus*, VI (6)
[13] IMF officials including Strauss-Khan and Lipsky have made open their commitment to assist Greece and an IMF technical mission was sent in mid-January although it has been denied that its purpose was to engineer a rescue package.

arrangements (i.e. bailouts) to multiple EU member states in Eastern Europe as well as offering a credit line to Poland, although it has yet to intervene in any euro area economy. IMF assistance generally comes in three forms:

- Flexible Credit Lines are provided to countries with sound fundamentals to prevent crises and are not attached to any specific policies. So far this new form of assistance has only given to Mexico, Poland and Colombia.

- Stand-by Arrangements form the bulk of IMF financing and seek to address short-term balance of payments problems, conditional on achieving programme targets. They typically run for 12-24 months and repayment is due 3-5 years after disbursement.

- Extended Fund Facilities are designed to help countries with more serious balance of payments problems and in need of fundamental reforms. They typically run for 3 or more years and repayment is due 5-10 years after disbursement.

Greece is unlikely to meet the criteria of a Flexible Credit Line, making a Stand-by Arrangement the most likely form of IMF assistance should it be required. Nevertheless, the possibility of an IMF-led bailout has caused jitters in the markets due to the perceived fallout on euro area credibility if there is a refusal to rescue one of its beleaguered members - even one which represents just a small share of the euro area economy. Attention has therefore focused on the way in which an EU-led bailout could be engineered even though this would fly in the face of existing EU statutes.

In fact, legally speaking the EU can do little to help Greece. The Maastricht Treaty was designed with a 'no bailout' clause to mitigate potential problems of moral hazard, a particular concern of the larger economies such as Germany which feared that they would ultimately have to come to the rescue of some of the fiscally irresponsible members on the European periphery. Article 103.1 of the treaty states:

> *The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to*

> *mutual financial guarantees for the joint execution of a specific project.*

Nevertheless, the Maastricht Treaty is not so rigid as to disallow financial assistance in its entirety, albeit limited to extreme circumstances as described in Article 100.1:

> *Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control**,** the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned.*

Despite this provision, Greece is unlikely to qualify - even the global crisis was only a contributing factor to a longstanding problem with the management of the public sector. As a result, any EU-led bailout would have to originate directly from the major EMU member states, such as Germany and France. Commitment to doing this has not been confirmed, in fact, a deliberate policy of "constructive ambiguity" has been described in order to force the Greek government not to scale back the reform agenda. Of course, this ambiguity has also had the negative effect of exacerbating market uncertainty, reflected in higher bond yields in the other euro area countries potentially at risk of their own fiscal crises as well as putting downward pressure on the euro (the latter, if anything, being a welcome side-effect given concern over the common currency's potential overvaluation).

Given the weaker euro and lack of an EU led bailout, it is PIIGS rather than the euro area that have felt the heat from the Greek crisis: their risk premia have picked up. However, the large euro area economies would shoulder the burden of upward pressure on their own risk premia if they were to step in to guarantee Greek debt. More likely is an informal form of assistance organised in conjunction with the main holders of Greek debt, the large European banks – they can be pressed to cooperate with Greece as long as Greece maintains its austerity programme.

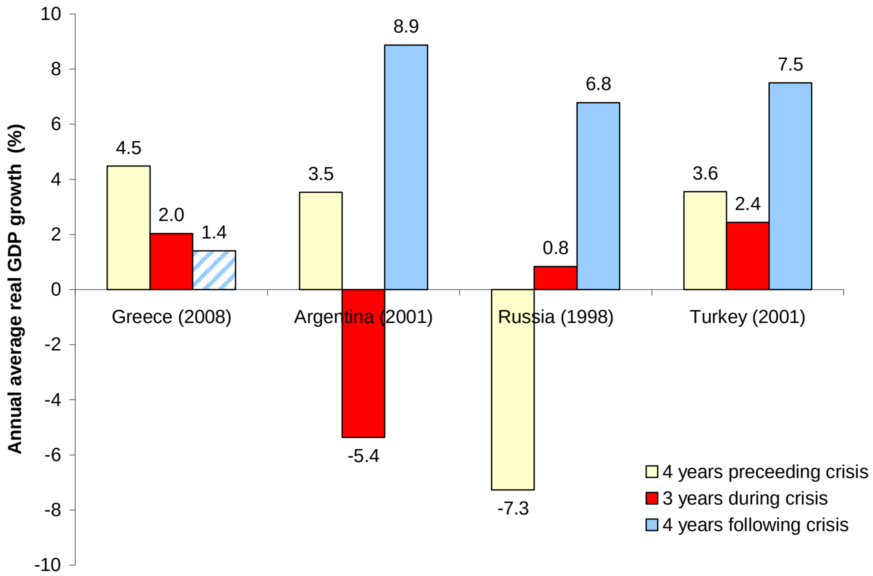
In spite of expected EU monitoring, it is still possible that further revelations could show Greece's debt problem escalating, especially if the deficits fail to fall this year. In this case, Greece may need an even more drastic market-led bailout – or will belatedly turn to the IMF. This cannot be ruled out. However, markets have become increasingly nervous even about private sector finance and the form of support Greece could find from foreign investors such as China: talk of such solutions seems to have done little to improve confidence.

## Abandoning the euro: would devaluation help?

By far the most extreme outcome of the Greek debt crisis would be if the government took the unprecedented step of quitting EMU. This move would clearly be seen as a prelude to devaluation – whether or not this really would offer Greece any remedy to its problems.

Although no EMU country has taken such a drastic step as to abandon the euro, there are historic precedents of countries abandoning currency pegs or other forms of fixed exchange rate regimes when faced with similar crises of readjustment, such as Argentina where the currency was pegged to the dollar until early 2002, or Russia which let the rouble float freely after renouncing its floating peg in September 1998. But in both cases, these countries were facing severe monetary constraints (both on the private banking sector as well as the central bank) to the point that it became impossible to maintain the pegs. That they managed to rapidly reduce external deficits after devaluation was partly due to steep domestic recessions while higher export growth after the devaluation was also due to their benefiting from a favourable external environment as well as competitiveness gains (Argentina and Russia were two of the prime benefactors of the commodity boom in the previous decade). Recovery from steep recession as well as the export stimulus also flattered post-crisis growth rates.

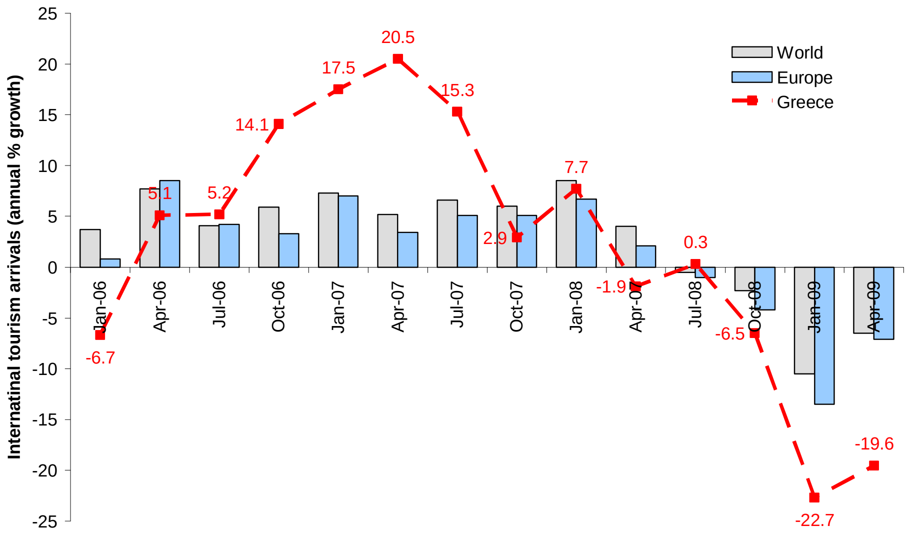
**Figure 5: Comparative GDP performance during previous crises**




*Source: IMF*

But expecting Greece's macroeconomic prospects in the next couple of years to turn around drastically if the country is allowed monetary independence would rest on a series of assumptions which are unlikely to hold in reality. As discussed previously, it is questionable whether devaluation would actually boost Greece's exports to the necessary degree to make its current account deficit manageable. This would depend on the price sensitivity of Greek exports, two-thirds of which are in the form of services. Results in this sector would be mixed. Tourism, for example, could theoretically see some positive benefits from cheaper prices yet the global tourism industry still sees a poor outlook for next couple of years: the UN World Tourism Organization estimates a 3-4% growth in tourism for 2010, still not enough to recover from the 4.3% decline in 2009. Being a highly cyclical sector, its growth will largely depend on the speed of recovery of the world economy, particularly in advanced economies where the bulk of tourism receipts ultimately originate from. Unfortunately, Greece suffers from the fact that most of its tourism comes from major European economies (mainly the UK, Germany and Italy) which are likely to experience continually weak consumer demand throughout 2010-11.

**Figure 6: International tourist arrivals up to Q2-09**

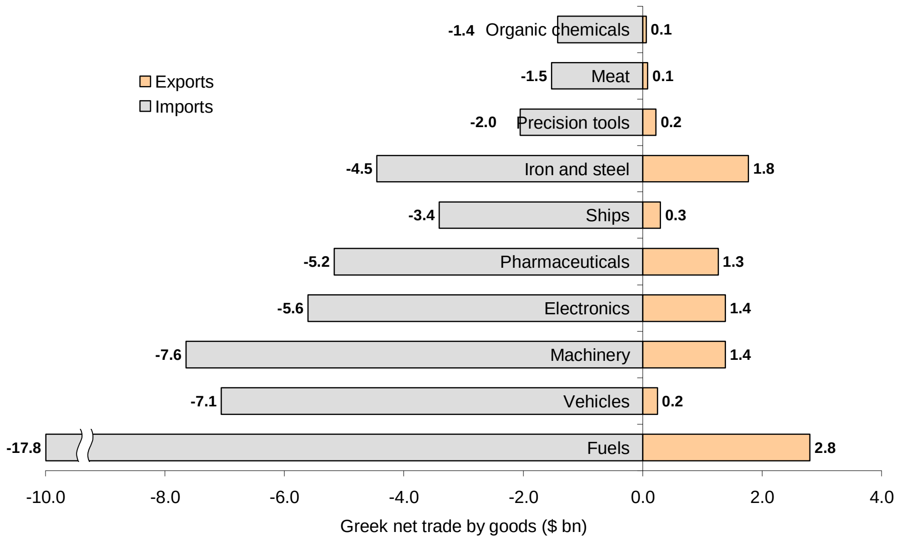



*Source: UNWTO*

The outcome for goods exports (which account for the largest share of Greece's current account deficit) would be even worse, given that only 54% of these are manufactures,[14] the rest being commodities which are far more responsive to global prices than domestic competitiveness. The assumption that devaluation would increase Greece's competitiveness enough to narrow the current account deficit therefore rests on the premise that lower prices would succeed in boosting exports in those goods where Greece's trade gap is widest. However, for many of these goods, Greek exports are virtually non-existent - it would be unrealistic to suggest that even substantially lower prices could narrow the trade gap when there is virtually no export market to begin with. And those sectors where Greek industry does have an export presence are already swamped with imports (notably durable goods as well as fuel exports, which are not price sensitive). Poor competitiveness in these sectors could in theory be partially corrected through lower prices but if local demand is outstripping domestic productive capacity, imports will continue to flood the domestic market anyway, regardless of the exchange rate.

[14] Germany's share of manufactures is 84% of their total exports of goods

**Figure 7: Greek trade gap by type of goods (2008)**




Note: These goods account for 77.3% of Greece's deficit in merchandise trade

*Source: ITC*

Alternatively, devaluation might boost those sectors where Greece already has positive net trade, offsetting the negative effect of import-heavy sectors. Unfortunately for Greece, the goods which have the largest positive balances are commodities (agricultural goods, minerals and cotton for example) which, as indicated earlier, are unlikely to see any benefit from a depreciated currency. And the net effect of these exports is minimal: they cover less than 5% of the trade gap in goods.[15]

Another factor which would affect the viability of devaluation would be the destination of Greek trade. Exports tend to gravitate towards the euro area (Italy and Germany are Greece's two major trading partners and account for one-fifth of all exports) as well as Greece's neighbours in south-east Europe (Bulgaria is Greece's 3rd largest trading partner, Romania its 7th). Demand in these areas is likely to be very sluggish during the next few years and probably fairly unresponsive to competitiveness factors. Additionally, there is likely to be fierce competition among all the SE European economies to tap into the same export markets - Germany in particular given its size - which means that there will be little scope for increasing market share.

[15] ITC data for 2008 showed the ten largest surplus sectors are offsetting only 4.8% of the trade deficit in goods

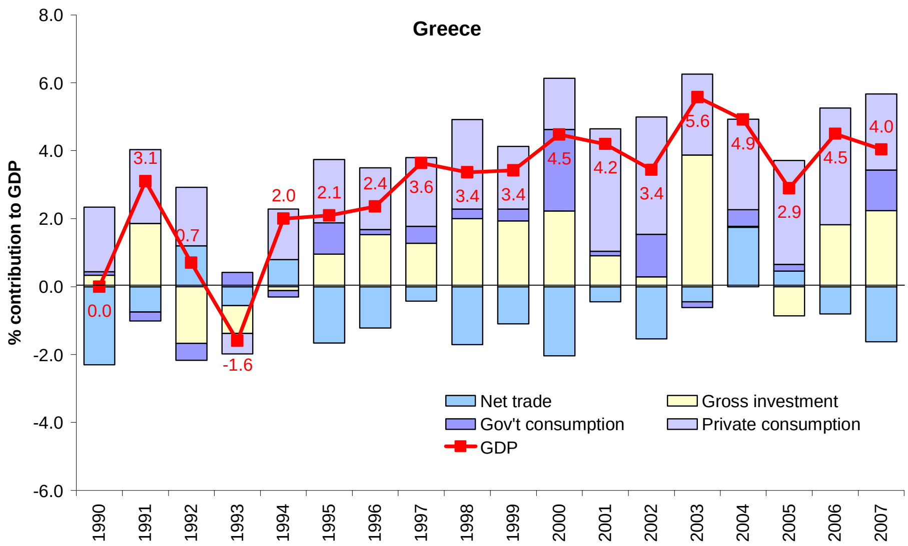
**Table 5: Destination of Greek exports (2008)**

| | % of total |
|---|---|
| Euro area | 43.2 |
| Central and Eastern Europe | 25.1 |
| APEC | 10.4 |
| United States | 5.0 |
| United Kingdom | 4.7 |
| Turkey | 3.6 |
| CIS | 3.4 |

*Source: IMF DOTS*

Lastly, it is important to note that export growth (in both goods and services) has broadly kept pace with imports since the 1990s, thus disproving the idea that failing competitiveness in recent years is the main culprit behind the trade deficit. Rather, this deficit is a historic legacy which Greece has been unable to shake off even though there has been some degree of rebalancing: in 1970, exports were barely half of imports but this ratio has shot up to about 70% in recent years. Comparing performance during the past two decades shows little difference in the effect of trade on growth: net trade was a drag on GDP expansion even before the euro was adopted in 2001. And there is little reason to suggest that devaluation could turn this around. Barring an unexpected and unlikely surge in export performance, the only way of cutting the deficit is through a contraction of consumption (the motor of Greek GDP) in order to bring down imports – Greece needs to keep growth at a lower, more sustainable, rate.

**Figure 8: Contributions to Greek GDP since 1990**




*Source: OECD*

It is clear that the textbook benefits of devaluation currently stand little chance of success in Greece given its mix of trade and export destinations. Added to which, there is also the issue of economic agents anticipating devaluation and therefore behaving pre-emptively in a way which would mitigate the effects of devaluation and lower prices. For example, organized labour would attempt to offset the loss of purchasing power by demanding higher wages – allied with rising import prices, this could lead to an inflationary spiral. This would take its toll on investment prospects and raise the country's overall risk premium in capital markets, which would have been impacted already by the loss of confidence linked to EMU exit. Past experience of devaluation cycles also suggests that effect of devaluation on the current account would be modest (and temporary) at best, while the other aspects of financial instability would be damaging to economic progress.

The drawback of exchange rate volatility is not insignificant. Any new Greek currency could be subject to speculative attacks while the country's monetary resilience was being rebuilt. The risk of further devaluations could result in capital flight from Greece. For households, firms and the government alike, the burden of existing euro-denominated debt would increase after devaluation, worsening public and private budgets. All in all, high borrowing costs, bank runs, and bond crises are hardly the scenarios contemplated by the advocates of abandoning the euro, but it is evident that the risks to financial stability by no means justify the monetary freedom which would be achieved by a new currency.

Lastly, it is evident that the process of abandoning the euro carries not only significant legal hurdles but technical ones as well. From a legal standpoint, a voluntary withdrawal from the EMU would imply a withdrawal from the EU given that euro adoption is a long-run obligation for all member states except for those which have negotiated op-outs. In fact, leaving the EU has been described as 'legally impossible' if done unilaterally and highly controversial if done in a negotiated manner.[16] And from the technical side, the costs of adopting a new currency would certainly be high, requiring changes in physical infrastructure, causing a significant burden on accounting, as well as causing considerable problems of re-denomination of existing claims. Adopting a new currency would be a protracted process which could easily

[16] For more information on the legal aspects of leaving the EU, see ECB (2009), "Withdrawal and expulsion from the EU and EMU: Some reflections", *Legal Working Paper Series*, No. 10 / Dec 09

take 1-2 years to fully implement, far too long to resolve the short-term financing problems which the Greek economy urgently needs to address.

## Choosing the right path to stability

It is impossible to doubt the necessity of structural reforms to the Greek economy. Although the stabilization policies which have been put forward by the government appears excessively austere and even draconian to many segments of Greek society, these measures have built up after long delays. The country now has to pay dearly for the misguided growth model which has prevailed in the past. This model, together with the credibility gained from euro entry, may have allowed Greece to narrow the gap with EU standards of living but it has proved to be as unsustainable as the old model of persistent devaluations. For far too long, the Greek public sector has acted as a bailout mechanism and benefactor of last resort to the economy at large, allowing the country to avoid the necessary private sector adjustments and the move towards more balanced growth – effectively a speed limit set by the natural pace of export expansion.

For the moment, the Greek government has committed itself to the policies established in its Stability Programme, which will be subject to various forms of EU supervision, particularly regarding fiscal transparency and external monitoring of the national statistical agency. Of overwhelming concern is that Greece meets its initial fiscal targets for 2010 and secures external financing to survive the deluge of obligations due, especially between April and May. After that, the fiscal situation will remain serious but not as critical and Greece could well benefit from reduced media scrutiny once the refinancing peak is past (and unless a crisis explodes elsewhere, as attention may turn to the rest of the PIIGS). However, the possibility of Greece requiring a bailout - mostly likely IMF led – or suffering a technical default cannot be ruled out without evidence of definite progress in reducing debt.

What is also clear is that drastic measures such as abandoning the euro will inevitably remain the topic of much theoretical speculation even if this has little practical consideration - the risks far exceed the likely benefits and the legal implications are severe.

What remains for Greece is a hard slog towards stability which will inevitably involve recession and fiscal austerity until imbalances are corrected and public finances become robust enough to restore credibility. Ironically, Greece would do well to learn the lessons of the fiscal problem children which came before it: Latin America suffered a 'lost decade' in the 1980s stemming from the debt crisis in 1982 and a further decade of financial instability. Yet now, most countries in the region managed to fight off the global crisis thanks to a few years of prudent fiscal management which paid off when it was most needed. The other lesson is from Korea during the Asia crisis, when it tackled debt problems harshly but quickly to emerge in better shape.

For Europe, the Greek crisis has come as an unwelcome challenge to its ability to defuse the risks emanating from its most vulnerable members, risks which threaten to affect the credibility of the region at a time when recovery from the recession is fragile, with recent results very disappointing. For the PIIGS, the crisis is a wake up call for structural reform which, despite the inevitability of hard times ahead, can serve as a catalyst for targeting a more sustainable growth model in the long run.