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Greece – the final chapter?

The deadline of 30 June is fast approaching and an agreement needs to be reached in order to release the last tranche of €7.2 billion of the second bailout programme for Greece. The deadline was initially set for 28 February but was postponed by four months after the general elections of 25 January. Greek citizens voted for the opposition party government in order to stabilise the situation in their country. Since 2009, the Greek economy has been in recession, GDP has been reduced by a quarter (equivalent to the decline in US GDP during the Great Depression of the 1930s) and relative to the European Union, living standards have fallen to lower levels than before the euro was introduced. This harsh adjustment has primarily stemmed from the extremely restrictive policies imposed on Greece by its "Troika" creditors (European Union, ECB, IMF). It is important to point out that these very restrictive policies were implemented in order to limit contagion risk from Greece to the financial systems in major eurozone countries right from the start.

The signing of an agreement on 30 June would help dissipate the risk of default by Greece and the country's eventual exit from the eurozone, with the negative consequences that this could have on the make-up of the eurozone.

What's at stake in the negotiations?

The stakes in these negotiations concern the terms of aid to Greece for releasing the remaining bailout money and to eventually set up a third round of debt-relief.

The difficulty of these negotiations lies in how different the stakes are for each party, depending from which side we are looking. For Greece, overly restrictive conditions could result in an ongoing situation of recession, which was not the reason why the nation elected Alexis Tsipras and his government. Neither were they elected to implement Greek's exit from the eurozone.

From the Troika's standpoint, the challenge is Greece's financial sustainability in order to be able to reduce the country's debt, secure commitments made in Greece and reduce risks in terms of the stability of the entire eurozone.

The challenges therefore concern how the future of Greece is projected

On the one hand, the Troika creditors want to be able to guarantee the sustainability of Greek public finances over the medium and long term in order to limit the impact of current imbalances on the rest of the eurozone. This means that the conditions need to be created for the country's public finances to improve over time and for the ratio of public debt to GDP to narrow, falling from 180% to 120% within a limited period of time. In order to achieve this, the Troika are calling for structural reforms that would enable the Greek government to generate a surplus in its primary budget balance (budget balance excluding payment of interest on public debt). The aim is to converge towards a primary surplus of 3.5% over the medium term (2018), whereas the figure is set to be lower than 1% this year. This involves both a decline in spending and an increase in tax revenues.

To reduce spending, the Troika insists on reducing public sector pensions. This involves a higher retirement age (a third of public sector employees retire at 55) and a reduction in pension payments. This is the key factor since the "pensions and wages" line item accounts for 75% of spending excluding interest. Pensions account for 16% of GDP and the aim is already to reduce this amount by 1%. The Troika would also like to see a wider VAT base in order to increase revenues rapidly and over time. Finally, a reform of the employment market is also requested with the aim of making the economy more flexible and more reactive, in order to increase growth potential. This would then enable a higher growth rate, in order to reduce the ratio of public debt to GDP more rapidly along with the other restrictive measures on public finances.

The Greek government is balking at these requests from the Troika, since the Greek economy has been in recession since 2009 and implementing these reforms would prolong the situation without providing the government any leeway to manage its economic policy. The adjustment has already been harsh and the government does not want this to continue since the decline in demand associated with these measures would be extremely penalising for economic activity and employment. The Greek government is therefore hoping to avoid hefty restrictions on its economy and to reduce its debt via restructuring.

Meetings this week

The challenge facing the Eurogroup meetings on 18 and 19 June and the meeting of government heads is to reconcile these positions and reach an agreement enabling the last tranche of financing to be released and the possibility, in a clearly defined framework, of implementing a prospective new round of bailout. The agreement must concern both the level of targets and the trajectory to follow. A high target for the primary surplus and a rapid convergence towards this level would be very penalising for Greece but very beneficial for the Troika since it's financing would be reduced. Inversely, lower targets and a slower convergence would benefit Greece but presumes higher and longer financing for the Troika in order to ensure the financial stability of the process. As

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such, the targets, instruments and profiles of each of these need to be clearly defined. In view of everything that needs negotiating, we understand why reaching an agreement is difficult.

If no agreement is reached this weekend, the situation is set to become more complex since each government needs time to implement the measures taken (parliament agreement for example).

What happens if no agreement is reached by 30 June?

Failure to find an agreement means Greece would not reimburse the EUR 1.6bn it owes to the IMF and would be considered as having defaulted. The agreement between Greece and its Troika creditors would no longer stand and the ECB would withdraw its financing to Greek banks. The European Central Bank had already changed its refinancing for Greek banks by making them go through a special procedure (ELA), which was slightly more costly. If no agreement is found, it would withdraw its financing, thereby placing the banks in a very difficult position, especially since capital withdrawals have already stepped up. If Greece defaults and this results in the country leaving the eurozone, the Greek currency would then be highly devalued compared with the euro and the purchasing power of capital left in the banks would be drastically reduced. This is why withdrawals are increasing, since the likelihood of default is rapidly increasing as the deadline looms. This is weakening the banking system, which would be all the more harshly affected if the ECB stops its refinancing. A financial crisis would rapidly be on the cards for Greece.

Grexit?

In addition to this, I believe that default and the halt to ECB refinancing would rapidly result in Greece leaving the eurozone. Indeed, if Greece cannot reimburse the EUR 1.6bn it owes to the IMF, how will it be able to find the EUR 6.7bn it needs to reimburse the ECB in July and August (reimbursement of the SMP portfolio built up by the ECB in 2010/2011). It would therefore be difficult to imagine a fresh compromise between Greece and its creditors. A "Grexit" would also imply leaving the European Union and abandoning a certain number of advantages, notably concerning trade within the European Union (price barriers) and the circulation of goods, capital and people.
A Greek exit would result in a financial crisis, the issuing of a new currency that would be significantly devalued relative to the euro, and the need to adjust the functioning of the Greek economy in order for it to regain the competitiveness necessary to prompt growth. This could result in a further plunge in activity. The risk is that the imbalances that have been so painfully absorbed (budget and current account) would re-emerge to a spectacular extent that would limit the incentive for any outside investors to step in to finance Greece
The situation would probably be even more violent than that witnessed recently but without the safety net represented by the European Union institutions and the eurozone. The risk of this result is not negligible since the associated question is that of the Greek economy's ability to spontaneously move back onto a growth path.

What would the eurozone lose?

At the same time, the eurozone has a lot to lose from a Grexit. The system's credibility would be deeply wounded since the system would then appear reversible. Consequently, other countries could leave, even though it would be under very different terms to Greece. This would prompt a general risk for the zone and a specific risk for the countries that might leave. The situation here would be very different to that of 2012 (period of sharp tension which prompted fears of a break-up of the eurozone) since at the time, no exit precedent had been set. This would be a major difference.

In addition, would the monetary system remain stable? The ECB could use the OMT procedure that has just been validated. This would add to already existing operations and create the perception of a greater risk associated with an unorthodox policy.
In my view, a good illustration of the impact of a Grexit is the Jenga building blocks game, whereby wooden blocks are removed one by one from a tower and placed back on top of the increasingly unstable structure. If we consider an exit by Greece as risk-free, it is as though we believe we are only removing the blocks from the top. But nothing guarantees this is the case and the risk is that the whole tower collapses. In this case, the situation in the eurozone would rapidly become chaotic.
The lack of credibility and mistrust concerning the construction of the eurozone, in particular by non-European investors, would result in high break-up risk for the zone. No one wants this since the monetary system would have to be redefined and public debts owned by members of the eurozone would become national again. As such, the share owned by an investor from the eurozone but non-resident would be valued depending on changes in the exchange rate of the country, the value of which is not defined. This could cause an out-of-control situation that is clearly better to avoid.

What conclusion?

The cost associated with a Greek exit could prove very high not only for the country itself but also for other countries in the zone since it could result in a break-up of the monetary construction.
If no one is prepared to take this type of risk, then it is likely that an agreement will be reached. It may not be restrictive enough for the Greeks and include the possibility of restructuring their debt (to offset the fact that the euro is too expensive for the Greek economy), but it would distance the risk of financial instability that could be associated with the exit of Greece.

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The meeting of government heads this weekend should at last enable a political answer to the question of eurozone construction. The targets desired need to be clearly defined via the compromise to be signed with Greece.

In the short term, I believe there are only two scenarios: either Greece defaults and leaves the eurozone, or an agreement is found in which each party alters its current position in order to make the objectives compatible. This is not necessarily the easiest path to take but it is nevertheless the least risky one.

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