

# The Greek Debt Crisis: What Are the Potential Scenarios Going Forward?

Ana Maria Santacreu, Economist

**T**he Greek debt crisis erupted in 2009, right after the Great Recession: Large government deficits and accumulated debt caused a fiscal crisis that resulted in bailout packages from the European Central Bank (ECB), the International Monetary Fund (IMF), and the European Commission (EC).

When the euro was established in 1999, investors started financing Greece and other periphery countries at the same low rates extended to Germany. These countries started borrowing extensively and building imbalances. When the fiscal crisis hit Europe in 2009, the markets panicked and imposed high interest rates, making it difficult for the indebted countries to repay their debts.

Sound macroeconomic policies are key to preventing solvency crises in a currency union.

The countries most affected by the crisis were those with the largest imbalances. In a currency union such as the European Union (EU), the buildup of imbalances may cause the union to lose credibility in the financial markets, since the countries with imbalances cannot devalue the currency to increase their competitiveness and generate growth. Hence, a currency union is very fragile to changes in investor sentiment.<sup>1</sup>

One way a country with a large imbalance could increase its competitiveness is through a so-called internal devaluation—the country reduces its labor costs by applying deflationary macroeconomic policies, such as decreasing wages or reducing the public deficit. The danger of this policy is that it may cause a recession and therefore increase the country's deficit and trigger a loss of credibility in the financial markets. Therefore, maintaining sound macroeconomic conditions in a currency union is key to achieving credibility in the financial markets and, hence, avoiding crises and contagion effects.

In 2010, the first Greek bailout of 110 billion euros was approved by the ECB, IMF, and EC; in 2012 these authorities approved a second bailout of 130 billion euros, along with a restructuring of debt, an extension of maturities, and a reduction of the interest burden on Greek sovereign debt. The bailout terms required strict fiscal austerity measures including reforming pensions and the labor market. In July 2015, Europe proposed a third bailout of up to 86 billion euros over three years in exchange for additional reforms.

Two possible scenarios could play out in the next several months:

- (1) Greece could successfully implement all the reforms, generate growth, and eventually repay all its debts, or
- (2) Greece could be in need of another bailout again in a few months, with renewed talk of “Grexit” (exit of Greece from the euro area) in the media and political discussions.

What would be the consequences for Europe and the global economy if Greece enters scenario 2? Those who argue against a Grexit often point to the negative consequences it could have on other members of the EU and the global economy in general based on (i) members' exposure to debt and (ii) their loss of credibility in financial markets if the euro zone weakens economically. Today, the exposure of other countries to Greece's debt is small. The bailouts of 2010 and 2012 shifted the exposure from private creditors to official creditors (e.g., the ECB, IMF, and EC).<sup>2</sup> Indeed, around 75 percent of Greek debt is held by these institutions. Yet, there are several other possible negative consequences of a Grexit.

In a recent article, Paul De Grauwe (2015) outlined possible outcomes if Greece leaves the euro and another negative shock hits the euro area: Periphery countries would be vulnerable to changes in investor sentiment because the countries cannot use independent monetary policy to promote growth.

Right now, Greece is the most financially distressed economy, based on its forecast of -1.0 percent nominal

growth and about a 2.2 percent interest rate on its debt. Moreover, among the periphery countries, Greece has the largest debt-to-GDP ratio—at about 180 percent of GDP. Based on these numbers, Greece would need to generate a surplus of 5.8 percent of GDP to sustain its debt.<sup>3</sup> Its current actual surplus is 2.1 percent of GDP. In contrast, Ireland and Spain would need surpluses of –0.4 percent and 1.2 percent, respectively, to sustain their debt.<sup>4</sup>

If Greece left the euro, a negative shock in the euro area could increase the risk premium for countries on the periphery (i.e., Ireland and Spain). So, even if these countries' debt looks sustainable today, increased borrowing costs could destabilize their debt, generating a self-fulfilling fiscal crisis. Ireland and Spain, for example, could be in the same position Greece is in now, creating an even worse problem for the EU.

Those in favor of a Grexit argue that a currency devaluation could increase Greek exports and economic growth. They use as examples the devaluation episodes in Argentina in 2002 and Mexico in 1994. The empirical evidence on the real effect of devaluations, however, is mixed. If an economy does not have a well-diversified production structure, a devaluation may not cause a large increase in exports. Moreover, a devaluation would increase the costs of imports and could have ripple effects in the economy by (i) increasing inflation, through imported inflation, and (ii) causing shortages of goods. For instance, production costs would increase for domestic firms that depend heavily on imported intermediate goods, which would hurt both domestic production and exports. Devaluation could also cause currency mismatches—that is, the value of debt denominated in foreign currencies could increase.

Another factor that can affect the benefits of a devaluation is the strength of the country's financial development. Because exporters tend to depend more on external financing than non-exporters, devaluation in a country with poor financial development could actually depress the economy. The devaluation in Argentina in 2002 coincided with a commodity boom that increased its export profits. After the devaluation in Mexico in 1994, Mexico was bailed out by the United States and the IMF, which prompted the North American Free Trade Agreement (NAFTA). Those actions along with the devaluation helped Mexico's economy recover. Other devaluation episodes were not as successful, and some of them were even contractionary.<sup>5</sup> Therefore, whether a devaluation could drive Greece out of the current crisis remains unclear. ■

## Notes

<sup>1</sup> For a detailed analysis, see De Grauwe (2011).

<sup>2</sup> Several commentators argue that the exposure to Greek debt by private creditors has been substantially reduced after the bailouts of 2010 and 2012. For a more-detailed analysis, see IMF (2013).

<sup>3</sup> These calculations are based on the formula for debt sustainability:  $\text{primary-surplus}/GDP = (r - g) * D/GDP$ , where  $r$  is the nominal interest rate on the debt,  $g$  is forecasted nominal growth rates,  $D$  is the total debt, and  $GDP$  is gross domestic product.

<sup>4</sup> See De Grauwe (2015).

<sup>5</sup> Empirical articles that find a contractionary effect of devaluations include Cavallo et al. (2005), Guidotti, Sturzenegger, and Villar (2004), Benavente, Johnson, and Morande (2003), and Bebczuk, Galindo, and Panizza (2006), among others.

## References

- Benavente, Jose Miguel; Johnson, Christian A. and Morande, Felipe G. "Debt Composition and Balance Sheet Effects of Exchange Rate Depreciations: A Firm-Level Analysis for Chile." *Emerging Markets Review*, December 2003, 4(4), pp. 397-416.
- Bebczuk, Ricardo; Galindo, Arturo and Panizza, Ugo. "An Evaluation of the Contractionary Devaluation Hypothesis." Working Paper No. 582, Inter-American Development Bank, July 2006; [http://www.iadb.org/research/pub\\_hits.cfm?pub\\_id=WP-582&pub\\_file\\_name=pubWP-582.pdf](http://www.iadb.org/research/pub_hits.cfm?pub_id=WP-582&pub_file_name=pubWP-582.pdf).
- Cavallo, Michele; Kisselev, Kate; Perri, Fabrizio and Roubini, Nouriel. "Exchange Rate Overshooting and the Costs of Floating." Working Paper No. 2005-07, Federal Reserve Bank of San Francisco, May 2005; <http://www.frbsf.org/economic-research/files/wp05-07bk.pdf>.
- De Grauwe, Paul. "Managing a Fragile Eurozone." *VOX*, May 10, 2011; <http://www.voxeu.org/article/managing-fragile-eurozone>.
- De Grauwe, Paul. "Greece Is Solvent But Illiquid: Policy Implications." *VOX*, July 3, 2015; <http://www.voxeu.org/article/greece-solvent-illiquid-policy-implications>.
- Guidotti, Pablo Emilio; Sturzenegger, Federico and Villar, Agustin. "On the Consequences of Sudden Stops." *Economia*, Spring 2004, 4(2), pp. 171-214.
- International Monetary Fund. "Ex Post Evaluation of Exceptional Access Under the 2010 Stand-By Arrangement." IMF Country Report No. 13/156, May 20, 2013.