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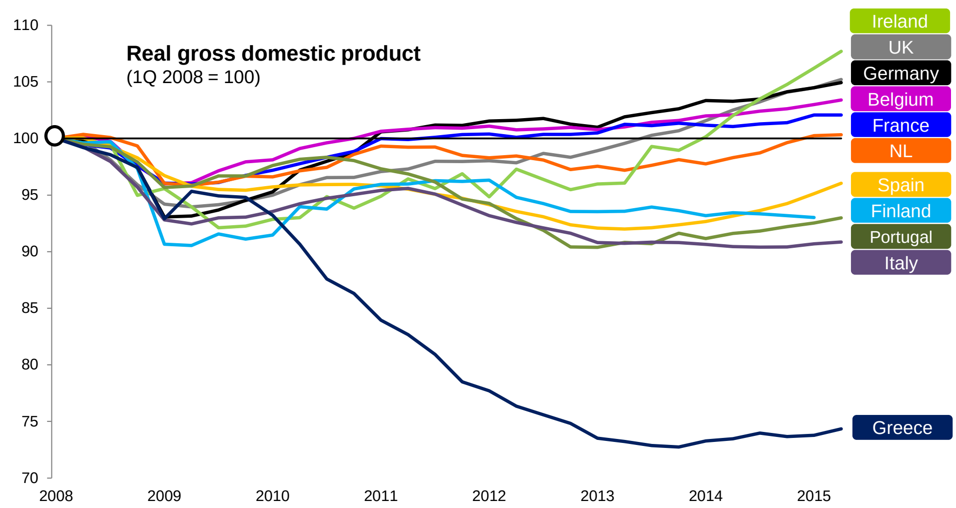
21 Lessons from the Greek Crisis

The messy last ditch deal struck between Greece and its creditors in July prevented it from crashing out of the Eurozone. But the decision by Greek Prime Minister Alexis Tspiras to call a snap general election shows that the saga is far from over. Here we suggest some lessons to be learnt.[1]

Fig 1 Eurozone GDP since 2008 – a Greek Tragedy



Source: Macrobond

The refinancing deal struck on 13 July between Greece and its Eurozone partners left everyone bruised and unhappy. While it staved off the immediate threat of yet greater chaos from Greece being forced to abandon the euro, doubts remain as to whether the deal will succeed. So what are the lessons to be learnt?

1. **The creditors remain in charge**. The radical left-wing Syriza-led government in Greece gambled that its international creditors would be so worried about the potential damage from a "Grexit" from the Eurozone that they would grant it softer terms on another bailout. It was wrong. Despite securing a strong 'no' vote in a last minute referendum on a package requiring it to deliver on reforms and further austerity measures, Syriza ended up having to capitulate to an even tougher deal.

2. **Politics trump economics, at least in the short run.** At times the numbers in the fiscal plans that the Greeks were proposing were very close to those suggested by its creditors, but the confrontational tone of the debate made it hard for politicians on either side to sell the deal to their voters.

3. **Trust matters**. The negotiations became acrimonious, and violent swings in bargaining positions (particularly from the Greeks) got in the way of striking a deal. In the

[1] This report is a modified version of an article published in the latest version of ING's on-line magazine ING World.
https://images.ingworld.ing.com/ext.dll?ID=nLUnU2YWdf%2BPDyFv6vEvDHBnGTaPYRB5BcHXTZznQ4p20KL98Z7AHpFnK88w0550e_i%2BkCpN99nhcpchVz

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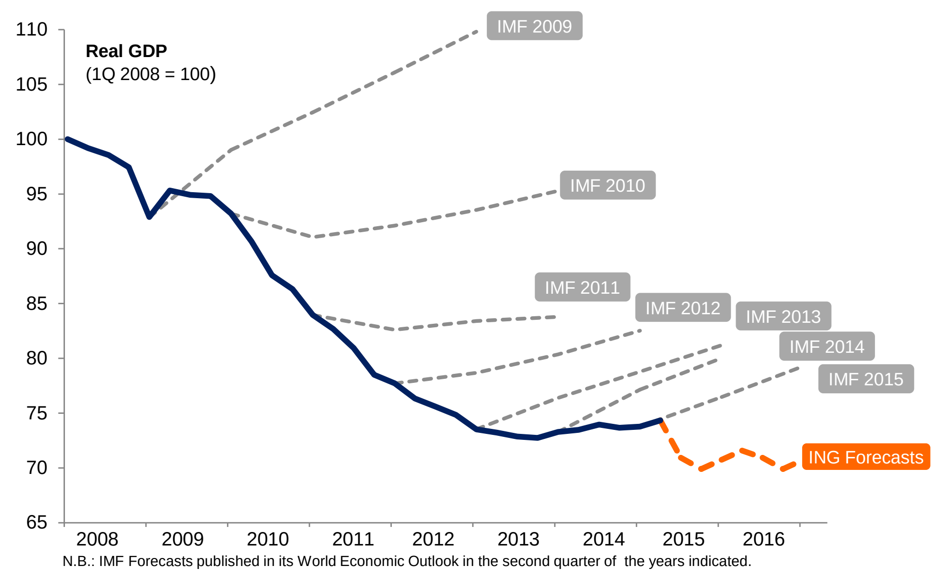
end, trust is essential in any financial transaction. Sadly, given that Prime Minister Tsipras criticised the deal as 'blackmail', mutual mistrust remains in short supply. The hope now must be that the forthcoming general election facilitates the creation of a new coalition that is more willing to implement the deal. This is far from guaranteed.

Fig 2 Greek GDP massively undershoots official forecasts since 2008



Source: Macrobond, IMF, ING

4. **Don't rely on economic forecasters**. Forecasts on the outlook for Greece, not least from its creditors, have repeatedly been woefully optimistic, drastically underestimating the damage to growth from budget cutbacks. Only a little over a year ago, the International Monetary Fund was forecasting that the Greek economy would grow by 4% in 2015, now it looks like it is shrinking by the same amount (see Fig 2).

5. **Severe austerity has a political price.** Syriza's support sprang from the depression in the Greek economy, which sent unemployment soaring to over 25% of the work force. This has bred resistance to further fiscal restraint.

6. **The more essential reforms become, the harder they may be to implement**. The wrangling over the last few months has inflicted more damage on an already weak Greek economy and fuelled a toxic political climate. Intrusive surveillance of reform implementation by foreign creditors may be required, but is likely to meet with hostility.

7. **Just because an economic strategy has failed, it doesn't mean it won't continue**. The combination of severe fiscal austerity and lack of reform has seen Greek government debt rise rather than fall. More austerity, in the shape of spending cuts and tax rises, has already been agreed, but it is not clear how far the pace of reforms will pick up.

8. **Make sure that you have an explicit and credible 'Plan B'**. After the deal was struck, former Finance Minister Yanis Varoufakis revealed that Greece, in case it failed to get external finance, had a secret 'plan B' to introduce a temporary currency linked to the euro. But with the banks closed and the economy struggling, the creditors believed that Greece had either to accept its terms or face an economic meltdown. Other populists elsewhere in the Eurozone will have to reflect on this before eyeing the Euro exit door.

9. **Game theory is tough to apply in practice**. Varoufakis, an expert in game theory, lost out on this one. Not only is the Eurozone a multi-player game, with each player having distinct motivations, it is also a multi-period game, rather than a one-off game: you

have to recognise that other players will remember how you behaved before, and act accordingly.

10. **There are deep-seated differences in thinking within the Eurozone not just on politics, but also economics**. The debate over Greece laid bare old divisions. On one side there is a German-led hard core emphasising rules, discipline and austerity and on the other the softer camp led by France and Italy advocating solidarity and growth.

11. **Fiscal union is a distant prospect**. There is little appetite to share economic burdens across the Eurozone. As a result, the original vision that European monetary union would be bolstered by a system of fiscal transfers from the richer to the poorer members looks further away than ever.

12. **The Eurozone will continue to have a deflationary bias in the event of future debt problems.** Debtors will be expected to deliver on budget cuts, with no matching expectation that creditors will offset this with fiscal stimulus measures.

13. **Generous welfare systems will continue to be under threat.** Drastic cuts to public spending in Greece, with pensions being a particular target, will send a message across Europe. The young will have less secure financial futures than their parents.

14. **The Euro is no longer irreversible**. German Finance Minister Schäuble's public advocacy of a temporary Eurozone 'time out' for Greece – for which there is no provision in its founding Treaty – has opened the door to future speculation that members could leave. This creates a precedent that may come back to haunt the Eurozone.

15. **Without growth, Greece will struggle to repay its debt.** There are plans to help with EU-backed investment programmes, but these are relatively small and are unlikely to be delivered until Greece delivers on austerity and reform measures.

16. **"Kicking the can down the road" makes it bigger**. Eurozone creditors remain reluctant to write-off Greek government debt, as advocated by the IMF. While politicians attribute this to Eurozone rules, it stems more from fears of a voter backlash if they acknowledge losses on loans to Greece. The strategy of lowering interest rates and lengthening the payback period on the debt – 'extend and pretend' or 'reprofiling' – is less embarrassing than partly writing off the debt, but is likely to prolong the agony.

17. **Interest rates will remain low**. Monetary policy will continue to carrying the burden of supporting economic growth. The European Central Bank will have to persevere with its programme of bond purchases ('quantitative easing') to hold down long-term interest rates.

18. **The euro will remain a weak currency**. While the ECB is set to be locked in to keeping interest rates low, the US and the UK are set to raise them in the next few months, driving the euro lower still.

19. **The rest of the world will have to live with weak demand from the Eurozone**. Although the recent hiatus in Greece may prove only a temporary blow to the recovery across Europe, economic growth is likely to remain lacklustre. Moreover, the weak euro will continue to make it hard for exporters to the Eurozone.

20. **Exports will continue to be the bright spot for Eurozone companies**. Producers in the Eurozone have benefited from the falling euro, which is making prices more competitive on world markets. The relative buoyancy of the US and the UK is also helping.

21. **Don't make important financial decisions at night**. The sight of bleary-eyed politicians announcing a deal at 7:00am after sixteen hours of negotiations should serve as a warning...

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