Alexis Tsipras and the call to Grexit in 2015

It is early 2015, and Alexis Tsipras is the Prime Minister of Greece. His Syriza Party has just won a convincing victory in the Greek parliamentary elections of January 2015.

Source: Reuters

The victory comes with a challenge. Greece, one of the fastest-growing European economies during 2000-2007, is now in the eighth year of an economic depression. Greek output has contracted by more than 25 percent since 2008. The unemployment rate for the labor force as a whole is at 27 percent. The unemployment rate for young adults is around 60 percent. The country is facing a health emergency; doctors regularly see people hospitalized because of malnutrition. While economic contraction has slowed, there are few signs of recovery. Syriza campaigned in this election with the promise of an end to this depression. In an early sign of his resolve to address the economic depression, Alexis has named you as his macroeconomic advisor.

The economic realities of his country for the last eight years should be viewed in the context of two important Greek macroeconomic policies. First, it is a member of the Euro Zone. The Euro Zone is a multi-country compact to use a single currency and to turn over monetary policy actions to a single independent central bank. The second is a negotiated agreement with the European Union to restructure Greece's daunting international debt payments in exchange for the Greek government's commitment to austerity in macroeconomic policy. The Syriza Party has been the opposition party in Parliament for the past three years and has strenuously objected to the government's implementation of these austerity policies.

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In January 2015, Alexis and his party ran on a platform of renegotiating the debt agreement while remaining within the Euro Zone. His economic advisers are split on this, though, because membership in the Euro Zone during this crisis is associated with eight consecutive years of non-positive economic growth. His economic advisers tell him that he has two important decisions to make: to abrogate the debt payment scheme or not, and to exit the Euro Zone or not. In their minds, these are two either-or decisions – and a decision for Greece to exit the Euro Zone (i.e., Grexit) is the only one promising positive economic growth.

Alexis Tsipras has turned to you for advice. Should the Greek government default on its international debts? Should it exit the Euro Zone? Are the two decisions connected in some way? He’s given you till next Monday to give him advice.

The Euro Zone.

The European Union (EU) is an economic and political union that currently brings together 28 European countries. It began as a customs union – an association of countries agreeing to the free flow of goods and services among its members. It also has assured the free movement of workers from one member country to another. The Maastricht Treaty of 1993 established the EU in its current form.

The Maastricht Treaty also set a timetable for the introduction of a common European currency – the Euro. After an extended period of harmonization of monetary policies across countries, the Euro currency was introduced as 'book money' on 1 January 1999 alongside national currencies and as Euro coins and banknotes on 1 January 2002.

The EU established rules and requirements for Greece and other potential adopters of the Euro. Monetary policy was transferred to the hands of the European Central Bank, which conducts it independently for the entire Euro Zone. Economic entry conditions for EU members were devised to ensure that the member's economy was sufficiently prepared for adoption of the single currency and could integrate smoothly into the monetary regime of the Euro Zone without risk of disruption for the member or for the Euro Zone as a whole. These entry criteria were defined in the Maastricht treaty and are known as the 'Maastricht criteria'. One such rule is the “three-percent” rule: government budget deficits of candidates for Euro adoption must remain below three percent of GDP per year. A second is the 60-percent rule: the stock of public and publicly guaranteed debt must be valued at less than 60 percent of GDP.[1]

The Maastricht Agreement originally previewed the introduction of the Euro in 1997, but a convergence report prepared by the EU in 1996 concluded that only three of the EU members (Denmark, Ireland, Luxembourg) were in compliance with the criteria. After this discovery, the date of Euro introduction was moved to 1999 and a second convergence report was commissioned in 1998. That second report found that 14 of the 15 EU members were in compliance, but Greece

[1] There are five Maastricht criteria, and they cover a member country’s inflation and interest rates as well as government deficits and debts. See https://www.ecb.europa.eu/ecb/orga/escb/html/convergence-criteria.en.html for details.

was not. The 14 were cleared for participation in the Euro Zone. A third convergence report in 2000 found that Greece was also in compliance at that time: it finally passed the three-percent rule. Greece too was cleared for participation.[2]

Adoption of the Euro as national currency has not been a requirement of the EU's members. When the Euro was first introduced, twelve EU countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) adopted it while three (Denmark, Sweden and Great Britain) did not.

Greece's last-minute clearance for participation in the Euro Zone has been subject to a great deal of second-guessing in recent years.[3] It is widely accepted now that in retrospect Greece had not in fact met the Maastricht criteria with respect to government deficits and government debt. Illustrating this, Table 1 indicates the statistics currently accepted by the IMF for those two variables in 1999 and thereafter.

Table 1: Government Deficits and Government Debt as a percent of GDP in Greece

	Government Net Lending (percent of GDP)	**Gross Debt** (percent of GDP)
1991	-10.7	74.7
1995	-9.4	99.0
1999	-6.1	98.9
2003	-7.8	101.4
2007	-6.7	103.1
2011	-10.3	172.1
2013	-4.1	177.9

Source: IMF World Economic Outlook, April 2017

The convergence report concluded that the government deficit was 1.6 percent of GDP, while in retrospect the IMF concludes that it was 6.1 percent. The convergence report concluded that the debt ratio had fallen by seven percentage points from 1996 to 1999, while Table 1 indicates that the relative indebtedness was largely unchanged over that period.[4] The convergence report's optimism on the continuing reduction of the government deficit and government debt indicators into the new century was not borne out in the data, as the table shows.

[2] The summary of the convergence report is at http://europa.eu/rapid/press-release_IP-00-422_en.htm?locale=en. Greece did not meet the 60-percent rule, even at that time, but the convergence report ruled that the measure of debt was falling from year to year and would soon meet the convergence criteria.

[3] See, for example, Weinberg (2011).

[4] The accounting "magic" that made entry into the Euro Zone possible for Greece is described in Little (2012).

Greece's Euro boom.

With Greece's entry into the Euro Zone came a prolonged period of economic growth. As Abascal reports, nominal GDP grew by 50 percent in the period 2002-2008. This was nominal annual growth of seven percent on average and real annual growth of 3.5 percent on average. Greece was among the leaders in the EU in growth of national product and income.

Despite the economic boom, the government budget deficit remained large. In addition, Greece's current account deficit widened over this period. Table 2 illustrates this growth in the current-account deficit with entry into the Euro Zone.

Table 2: Current Account Balance, Domestic Credit and the Real Interest Rate

	Domestic credit to private households (percent of GDP)	Current Account Balance (percent of GDP)	Real Interest Rate (percent per annum)
1990	31.1	-3.6	5.7
1991	29.4	-1.5	8.1
1992	28.7	-1.8	12.1
1993	26.7	-0.7	12.3
1994	26.6	-0.1	14.6
1995	28.9	-2.1	12.1
1996	29.6	-3.1	12.4
1997	30.5	-3.4	11.6
1998	32.2	-4.2	12.8
1999	39.0	-5.1	11.0
2000	45.3	-7.5	10.6
2001	50.1	-6.9	4.9
2002	53.3	-6.2	3.9
2003	57.2	-6.3	3.2
2004	62.3	-5.6	6.3
2005	72.0	-7.4	6.1
2006	76.3	-10.8	4.2
2007	84.5	-14.0	4.1
2008	89.3	-14.5	4.1
2009	88.0	-10.9	5.9
2010	111.6	-10.1	9.1
2011	117.2	-9.9	9.3
2012	116.8	-2.5	8.6
2013	118.1	-2.1	10.2
2014	116.7	-1.6	9.3

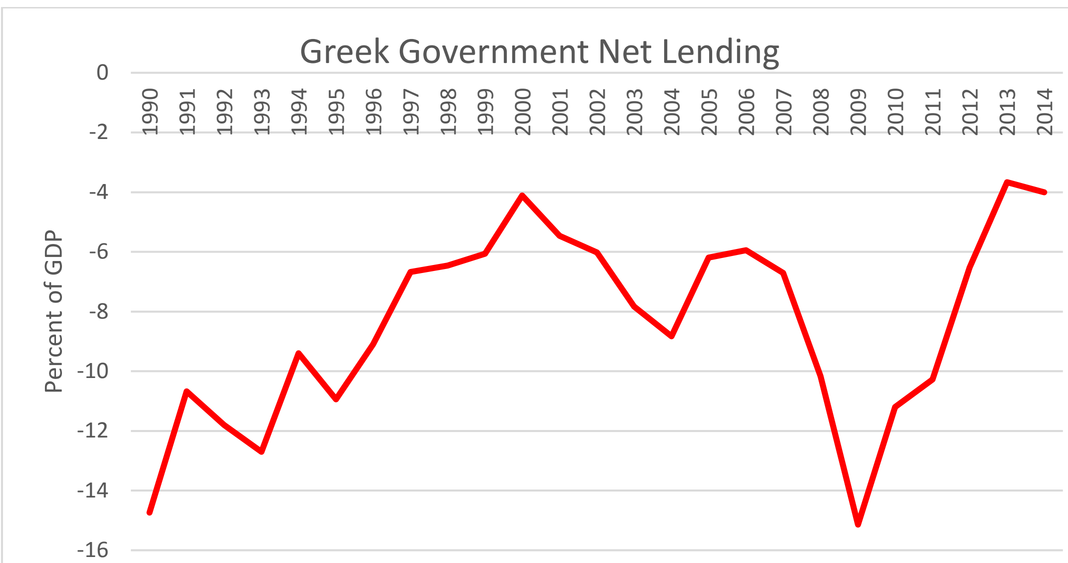
Source: World Economic Outlook, IMF

The different evolution of private and public debt in the "Euro boom" period is illustrated by comparing Table 1 and Table 2. Gross public and publicly guaranteed debt remained at roughly 100 percent of GDP during the 2000-2008 period. By contrast, private debt (as measured by domestic credit in the table above) rose very substantially. The evolution of the real interest rate (the private lending rate adjusted for inflation) provides one explanation for this growth. That evolution is illustrated in the last column of Table 2.

Greece's debt crisis of 2009.

The international financial crisis of 2008 took Greece as an early casualty: its high level of existing government indebtedness at that time left it unable to finance the large budget deficits incurred during the resulting recession.[5] The combination of a left-leaning government and a massive increase in expected deficit had a chilling effect on international lenders. All three bond-rating agencies downgraded Greek government debt, and lenders insisted upon a four percentage-point risk premium when purchasing Greek government debt. This was too high a price for the Greek government to pay in financing its current budget deficits or in refinancing the debt service due on its existing debt.

Figure 1



Source: International Financial Statistics, IMF, 2017

In its quest to refinance its debt, the Greek government entered a prolonged negotiation with the "Troika" – a representative committee of Greek's creditors drawn from the European Union, the European Central Bank (ECB), and the International Monetary Fund (IMF). In these negotiations,

[5] The government's cause was not helped by the change in government in early 2009. The right-wing New Democracy party had been in power from 2005, and had introduced austerity measures to bring Greece in line with the Maastricht criteria. After the October 2009 election, the center-left PASOK party formed a government, and promptly announced that the government budget deficit for 2009 would not be 3.5 percent of GDP as the previous government had indicated: it would in fact be 12.5 percent of GDP. As the figure below illustrates, that too was an underestimate.

the Troika insisted upon austerity measures that were deeply unpopular with the Greek citizenry. The PASOK government implemented these reforms, leading to riots and strikes in Greece in the first half of 2010. In return, Troika provided a €110 billion (about USD $145 billion) financing package. Simultaneously, the EU created the European Stabilization Mechanism “to present financial stability in Europe” by providing guarantees of up to €500 billion (about USD $660 billion) sovereign borrowing from international capital markets.

The Troika’s second financing package was ratified in February 2012. A total of €240 billion was to be transferred in regular tranches through December 2014. Parliamentary elections in 2012 illustrated the deep split among Greek voters. No one party was able to form a government, leading to the president’s intervention to form a coalition government with New Democracy (center-right) and PASOK (center-left) as lead members and Antonis Samaras as prime minister. The left-wing Syriza party had the second-highest number of members in Parliament and formed the opposition. The period from 2012 to 2015 was characterized by continuing austerity and market reforms insisted upon by the Troika as well as growing anger among Greek voters. Evidence of the continuing austerity: consumer prices declined by four percent over the period and nominal wages declined by over seven percent, leading to a decline in the real wage. The overall unemployment rate remained stubbornly around 27 percent while the unemployment rate for young workers was nearly 60 percent. The government’s budget deficit had declined to about four percent of GDP: still large, but much improved from the 14-percent-of-GDP budget deficit of 2010. The primary balance (excluding interest payments) actually moved into surplus. The current account had returned to near-balance. At the same time, the government debt as a proportion of GDP continued to climb, and is nearly twice as large as when Greece entered the Euro Zone. Credit to households continues to increase in comparison to GDP, and the share of these loans that are non-performing continues to rise.

Greece: the view in 2015.

Alexis and his Syriza colleagues face a difficult economic landscape in early 2015. GDP per capita remains about 75 percent of its value in 2007, and real wages for workers are 73 percent of their 2007 value. Unemployment remains at 27 percent of the labor force. The twin deficits (budget and current account) have been brought close to zero, but the indebtedness of the private sector and the government is as extreme as it has ever been. The real interest rate has returned to the range of values observed in Greece prior to the introduction of the Euro. Table 3 illustrates the evolution of these macroeconomic indicators in the last four years.

Table 3: Macroeconomic Characteristics of Greece in Recent Years

	Domestic credit to private households (percent of GDP)	Government Gross Debt (percent of GDP)	Real Interest Rate (percent per annum)	Current Account Balance (percent of GDP)	Government Net Lending (percent of GDP)	Real Wage (2007=100)	GDP per capita (percent of 2007 value)
2011	117.2	172.1	9.3	-9.9	-6.5	88	81.5
2012	116.8	159.6	8.6	-2.5	-3.7	79	76.0
2013	118.1	177.9	10.2	-2.1	-2	72	74.0
2014	116.7	180.9	9.3	-1.6	-1.6	73	74.8

Alexis has turned to you as his advisor. To paraphrase his charge to you: We as a country have two choices to make. Should we continue to service our public debt held by international creditors? Should we remain in the Euro Zone? What will be the best outcome for Greece?

He's asked for your advice by the end of the week. Time to get to work answering these questions!

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