# The Challenges of the Greek Debt Crisis


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# Outline

1. The Euro: A (Very) Brief History
2. The Greek Crisis and the Challenges for Greece
3. Challenges for the Euro
4. Challenges for the IMF
5. Challenges for Federal Reserve

# The Euro: Origins

- 1945-1973: Bretton Woods
  - Universal fixed exchange rates

- 1979-1999: European Monetary System
  - Members fix currency values against each other
  - West German mark predominant currency
  - 1992: Currency crisis, United Kingdom and others exit

- 1999-?: European Monetary Union (euro)
  - 19 member nations
  - European Central Bank

# The Eurozone: Members

# The Euro: Head of ECB

# The Euro: Advantages and Disadvantages

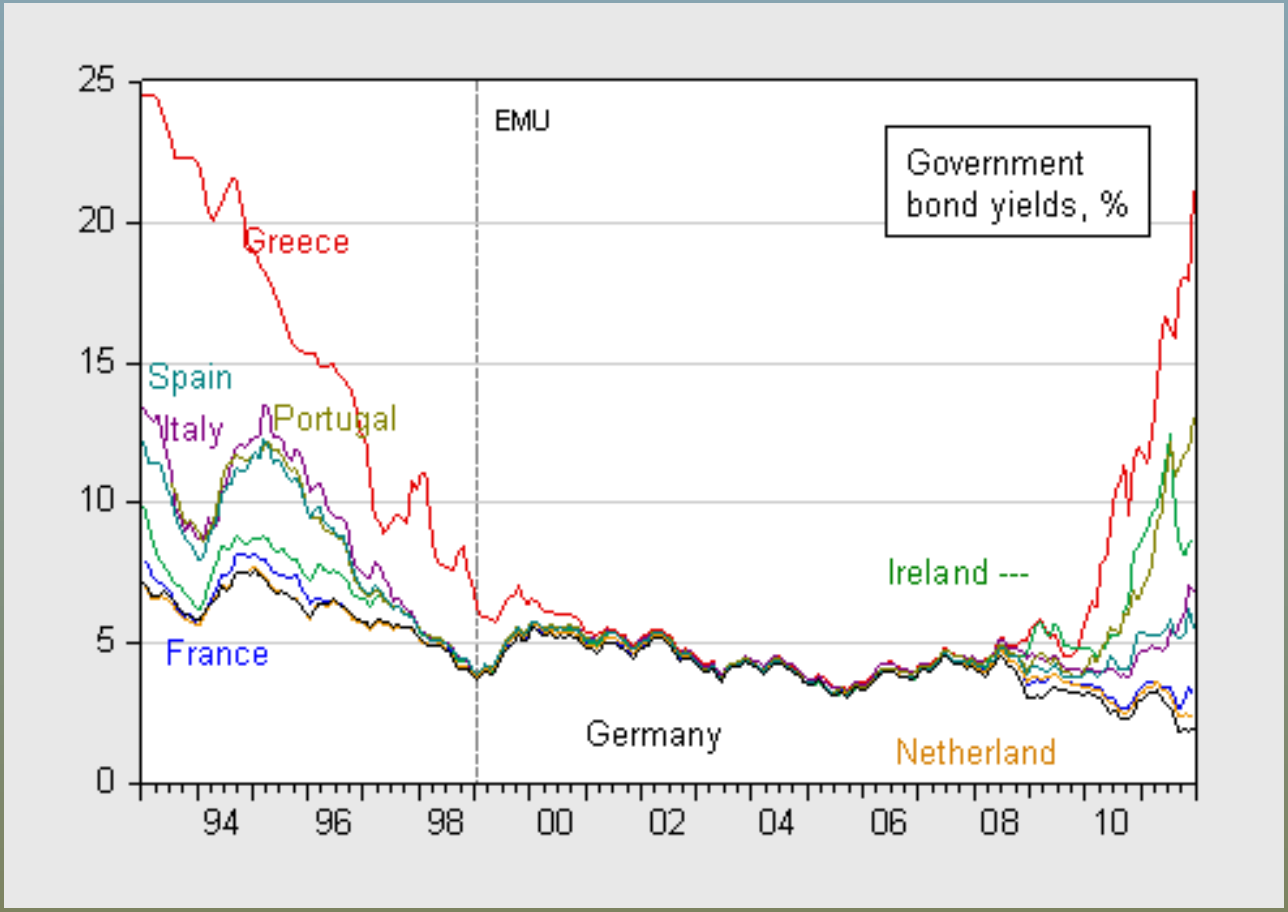
- Advantages of common currency:
  - Easier comparison of prices across countries
  - Lower transactions costs in international trade
  - Strengthening of political ties

- Disadvantages of common currency:
  - No national monetary policy to deal with shocks
  - No exchange rate to use as policy tool
  - National fiscal policies can be disruptive

# The Euro: Greece's Entry in 2001

- Criterion: Budget deficits/GDP < 3%
- Actual Greek deficits: 1997: 6.4%, 1998: 4.1%, 1999: 3.4%
- Average budget deficits 2001- 2008: 5%
- But Greece could borrow money at low interest rates

# The Euro: Convergence of Interest Rates



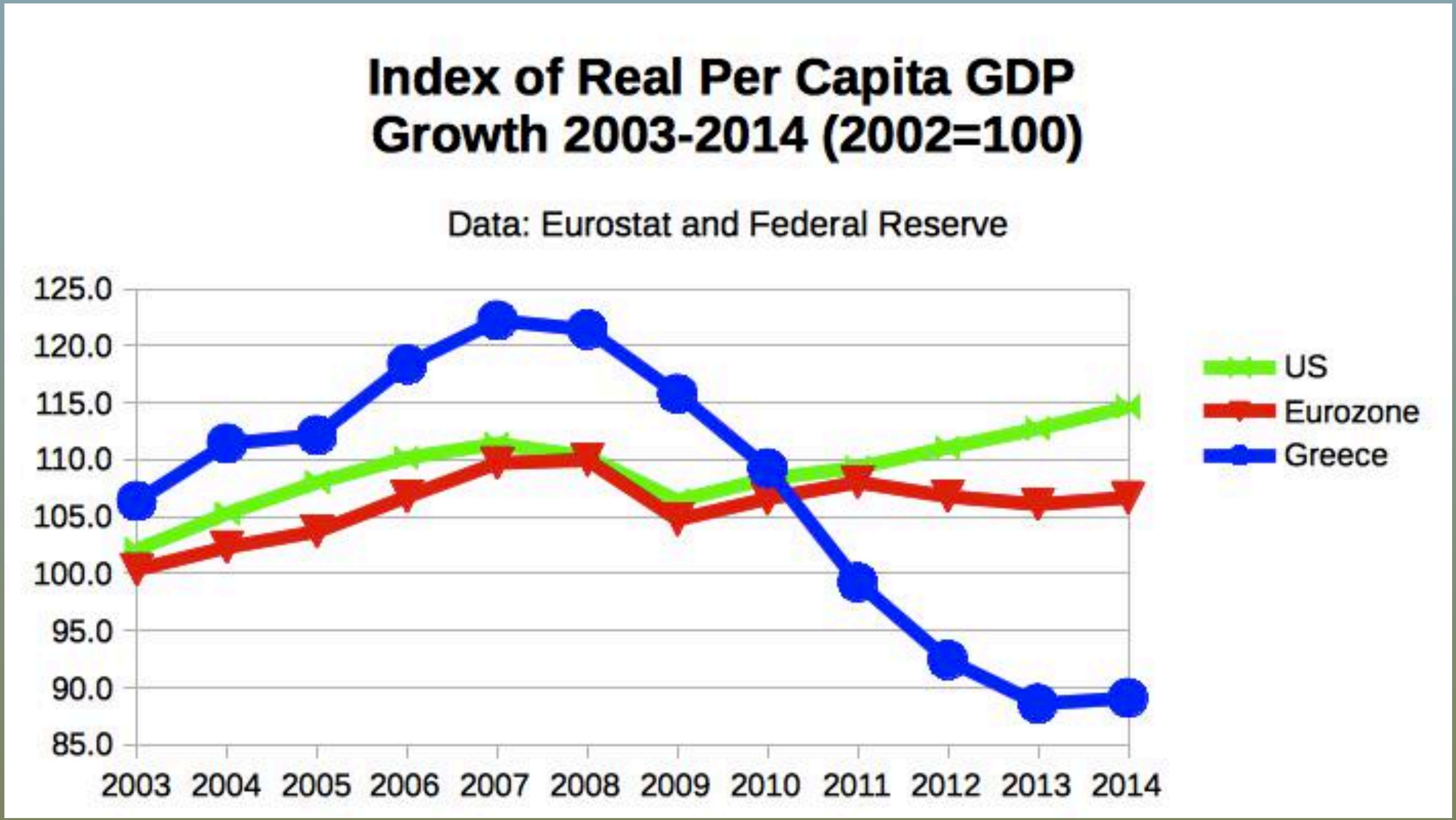
# Greece: Background of Crisis

- 2008-09: Global Financial Crisis
  - World economy contracts, slowly recovers
- 2010-?: European Government Debt Crisis
  - Greece: debt of €330 billion, 148% of GDP
  - Ireland: debt of €144 billion, 91% of GDP
  - Portugal: debt of €162 billion, 94% of GDP
  - European Union: debt 80% of GDP

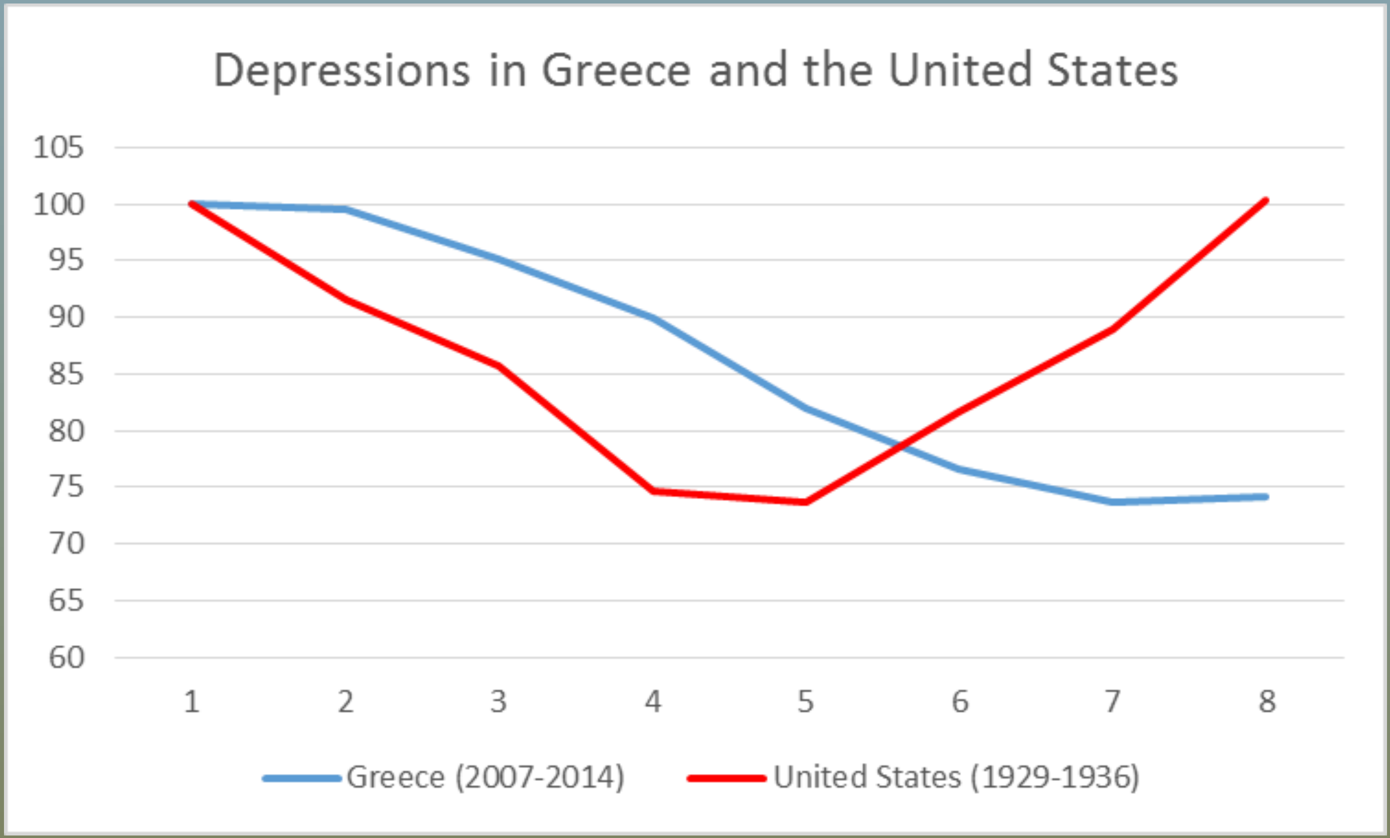
# Greece: Response to Crisis

- May 2010: European Commission, European Central Bank, IMF (“Troika”) lend $145 billion to Greece
- Deficit to be lowered from 14% of GDP to < 3% by 2014 through spending cuts, higher taxes (“austerity”)
- Budget target achieved, but GDP ↓ 5.4% (2010), ↓8.9% (2011), ↓6.6% (2012); debt/GDP continues to rise
- February 2012: new rescue package of $175 billion based on debt reduction, more budget cuts

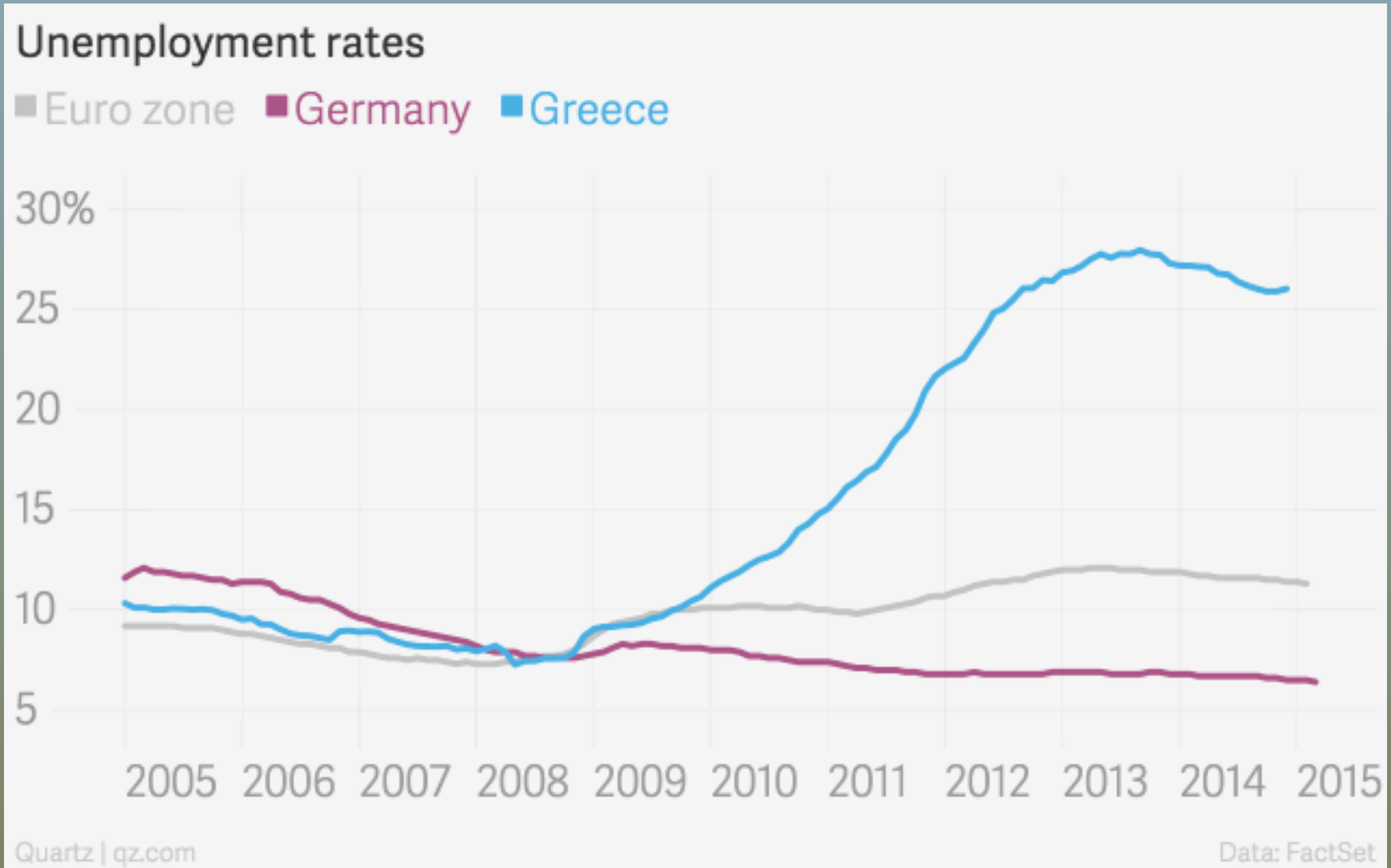
# Greece: Impact of Crisis



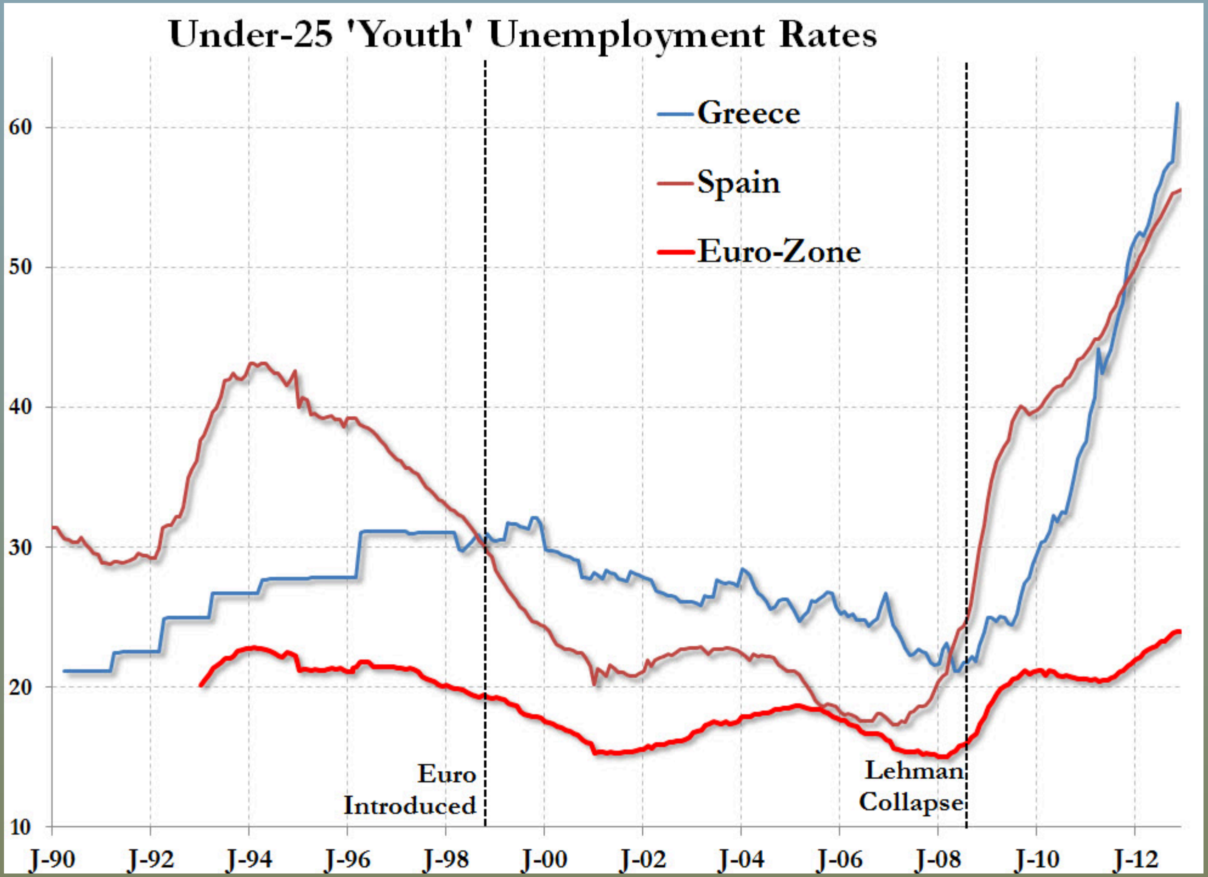
# Greece: Impact of Crisis



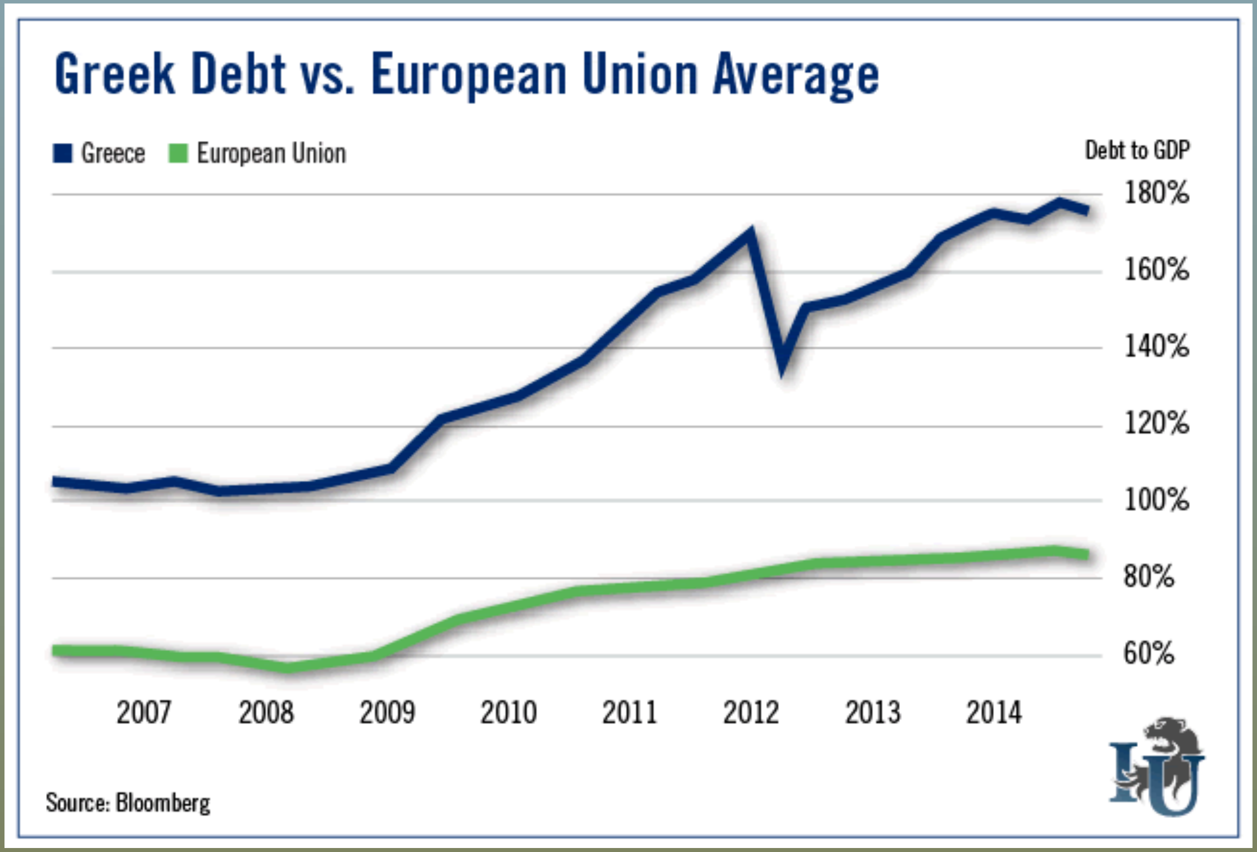
# Greece: Impact of Crisis



# Greece: Impact of Crisis



# Greece: Debt



Greek Debt vs. European Union Average
Greece
European Union
Debt to GDP
180%
160%
140%
120%
100%
80%
60%
2007
2008
2009
2010
2011
2012
2013
2014
Source: Bloomberg

# Greece: Why is Crisis So Severe?

- Deep cuts in government expenditures
- Sharp decline in investment expenditures
- No offsetting change in monetary policy
- No change in exchange rate
- Limited exports (tourism)

# Greece: 2013-2015

- Greece: GDP ↓ 3.9% (2013), ↑ 0.8% (2014)
- January 2015: Syriza, left-wing party, wins elections

# Greece: 2015

- Prime Minister Alexis Tsipras seeks new agreement with Troika with relaxation of austerity conditions, more debt relief

- Germany, other European governments refuse to withdraw conditions or cancel debt

- July: government defaults on repayment to IMF, shuts banks and limits withdrawals, agrees to new conditions for third bailout

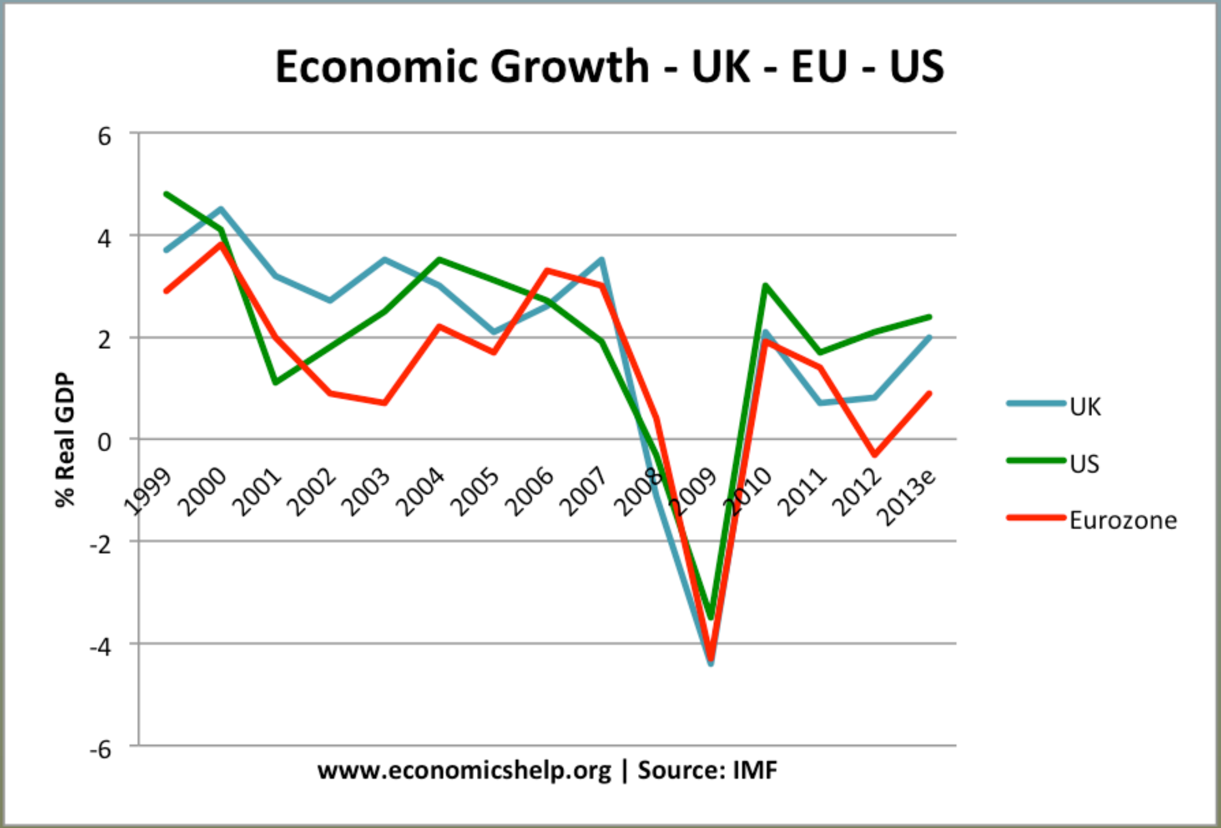
# Greece: 2015 Agreement

- Budget surplus of 1% of GDP, rising to 3.5% in 2018
- Automatic spending cuts if budget targets not met
- More items subject to VAT tax of 23%
- Sale of government assets
- Reform of pension system

# Challenges for Greece

- New agreement destined to fail: fiscal goals too ambitious, no basis for recovery
- Long-term unemployment hurts future growth
- Brain Drain: emigration of young, well-educated
- “Grexit”: Greek exit from Eurozone? Temporary? Permanent?

# Challenges for the Euro



# Challenges for the Euro

- Short-term: Debt/GDP > 100%: Italy, Portugal, Ireland, Cyprus, Belgium
- Long-term: How to raise growth?
- Is Eurozone with current rules feasible?
- Does monetary union require fiscal union?
- Possible outcomes: limited breakup? full breakup?

# IMF: Purpose

- IMF is an intergovernmental organization with 188 member governments
- Seeks to provide International Public Good (IPG): International Economic and Financial Stability
- Part of Bretton Woods system (1945-1973) to supervise compliance with rules of system and provide credit in times of crisis

# IMF: Crisis Preventer

- Surveillance: monitors macroeconomic policies of members and consults with them
- IMF has no power over members that do not borrow from it
- IMF dominated by nations with largest quotas (Canada, France, Germany, Italy, Japan, U.K., U.S.)

# IMF: Crisis Manager

Organizes lending programs with conditions:

- Macro: less government spending and credit creation
- Structural: removal of restrictions on private markets (*Washington Consensus*: "stabilize, privatize, liberalize")

IMF criticized for its crisis management in late 1990s/early2000s:

- Slow to respond and disburse credit
- Imposed too many conditions
- Conditions harsh and inappropriate

# IMF: 2008-09

IMF’s Response to Crisis:

- Lent quickly and in large amounts
- Imposed fewer conditions
- Accepted fiscal measures to support growth

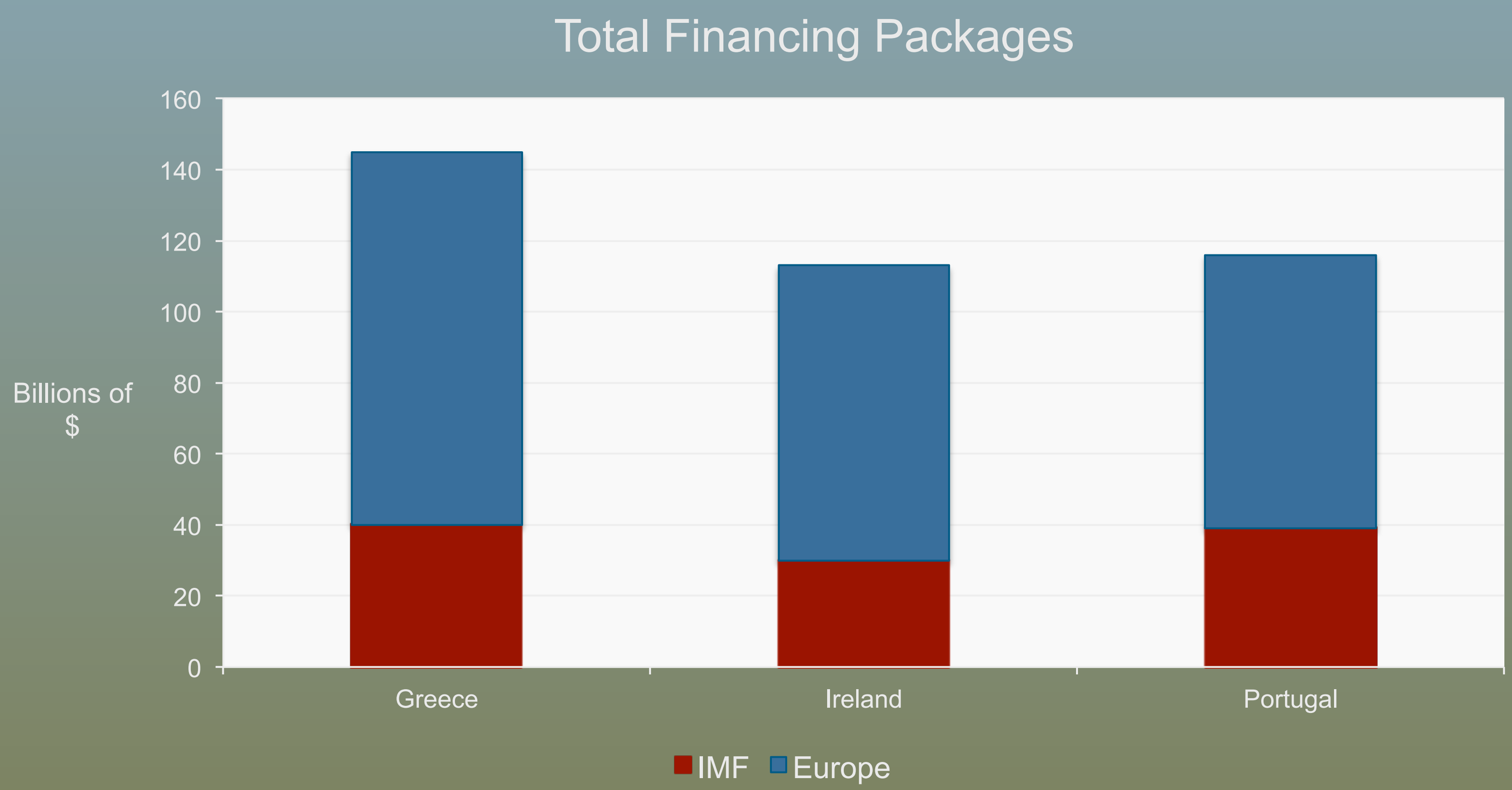
Results:

- Resumption of economic growth
- Less severe fiscal adjustment
- Avoided disruptive exchange rate movements

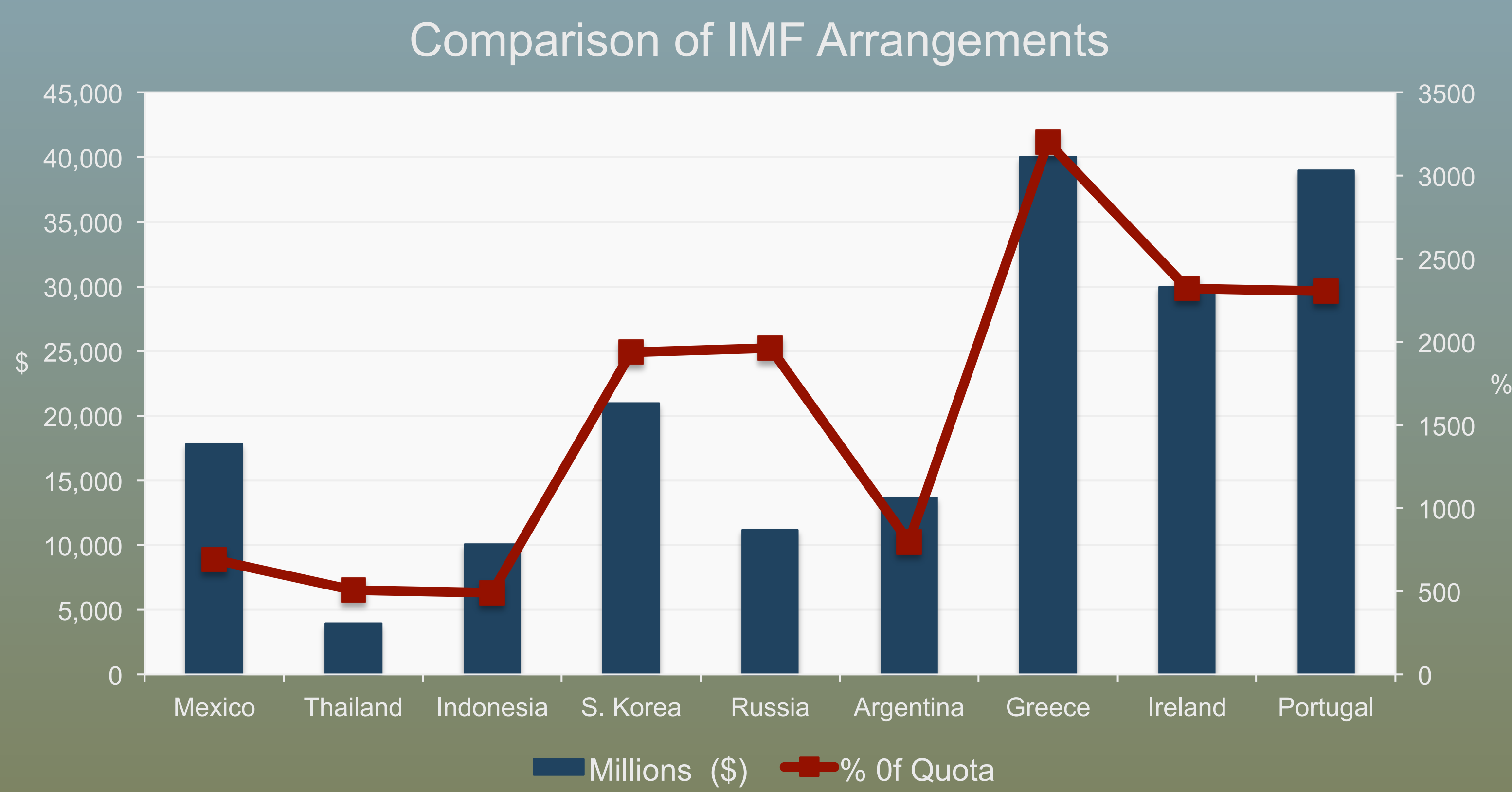
# IMF: Greece, 2010

- First loan to Eurozone member, first with “Troika”
- Loan to Greece largest in IMF history
- Violated IMF’s guidelines that government debt would be sustainable
- IMF justified loan on grounds of high risk of international spillover

# IMF: 2010


Total Financing Packages
Billions of $
160
140
120
100
80
60
40
20
0
Greece
Ireland
Portugal
IMF
Europe

# IMF: 2010


Comparison of IMF Arrangements
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
$
3500
3000
2500
2000
1500
1000
500
0
%
Mexico
Thailand
Indonesia
S. Korea
Russia
Argentina
Greece
Ireland
Portugal
Millions ($)
% 0f Quota

# IMF: Greece

# IMF: Greece, 2015

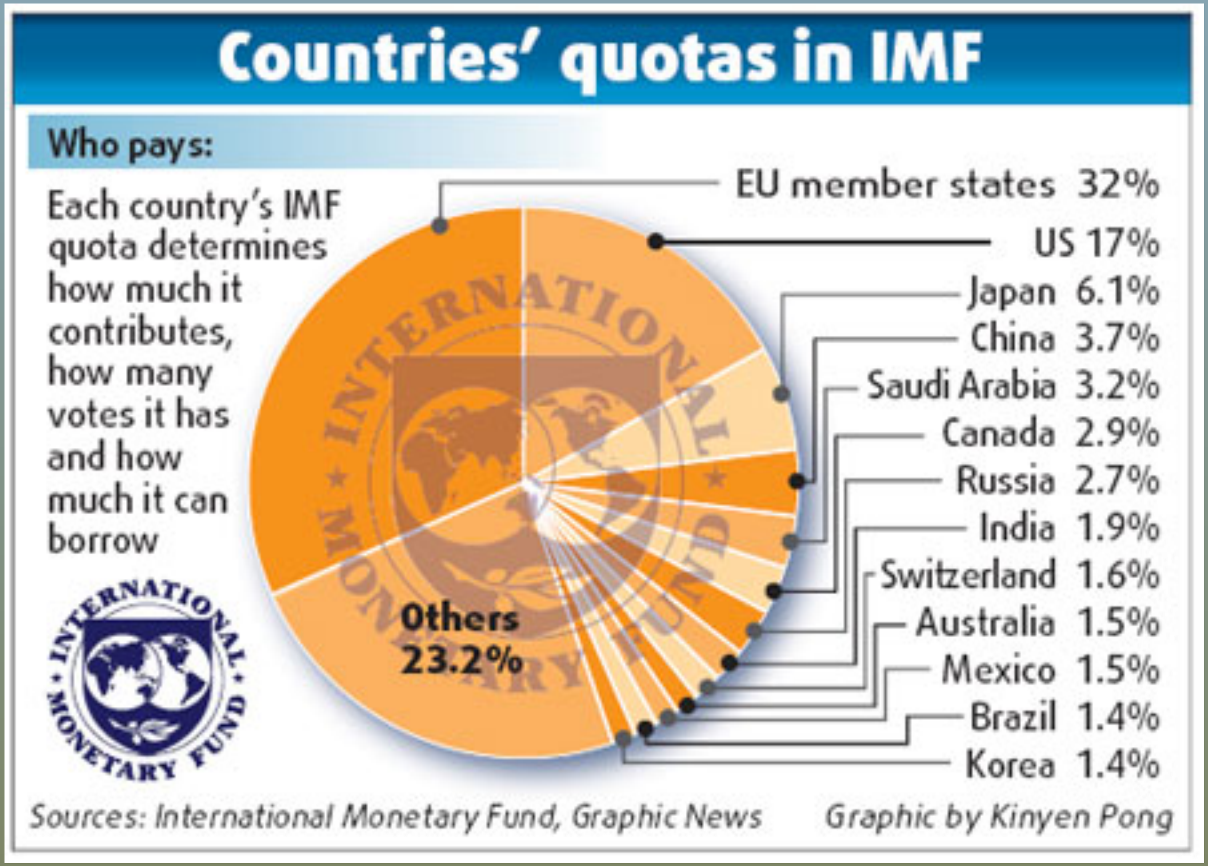
- Greece defaults on repayment to IMF

- IMF tells Eurozone governments:
  - Budget and GDP growth forecasts in new plan for Greece are unrealistic
  - Debt can only be sustainable through more relief measures
  - IMF may not participate in next program

# IMF: Program with Greece

- IMF responded to pressure from European governments in granting loan
- IMF violated own rules in approving loan
- Conditions of 2010 program too harsh
- But IMF has admitted errors

# Challenges for IMF

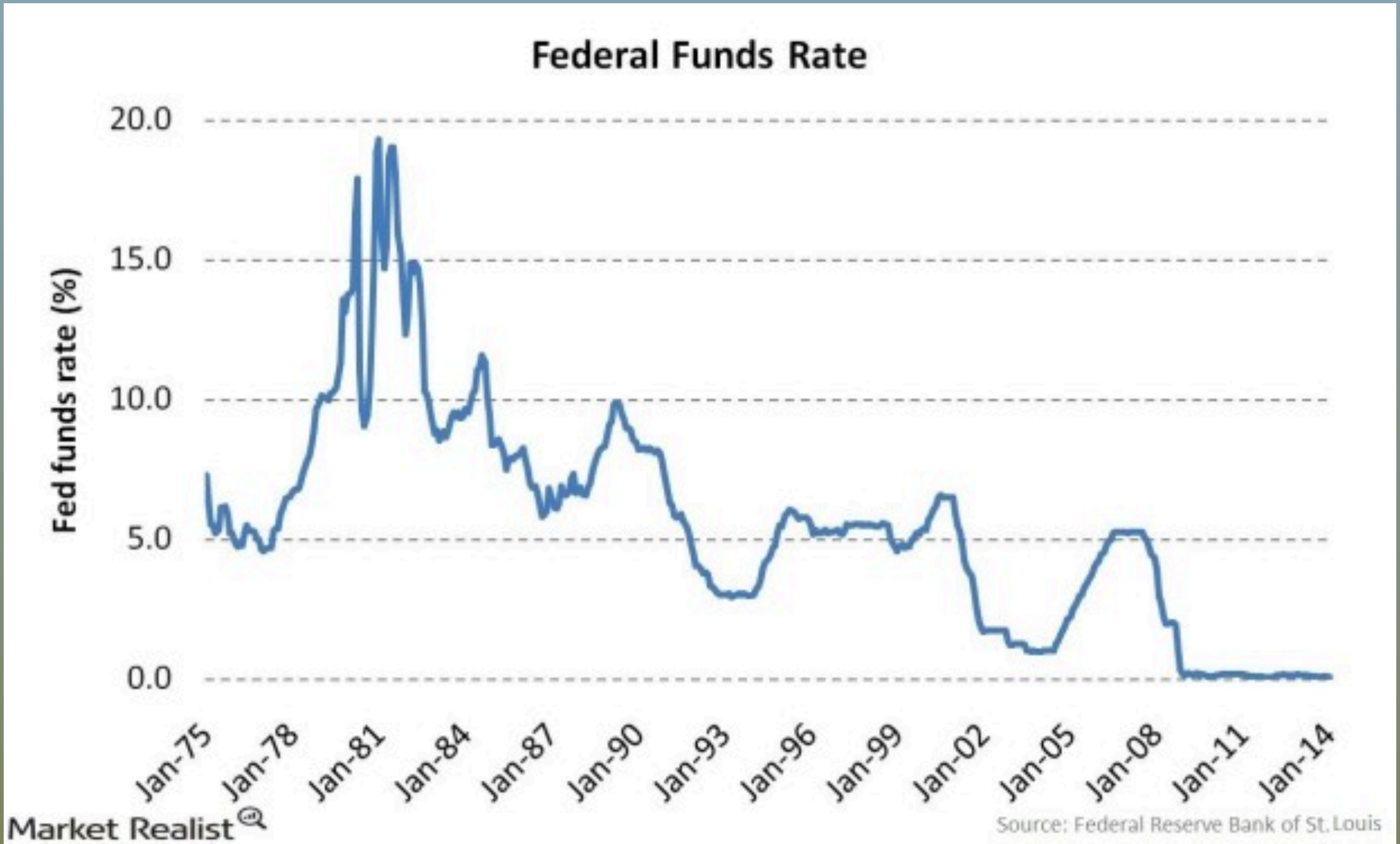



This is your World
This is your World on IMF
*Based on Regional Voting Power
© New Rules for Global Finance

# Challenges for the IMF

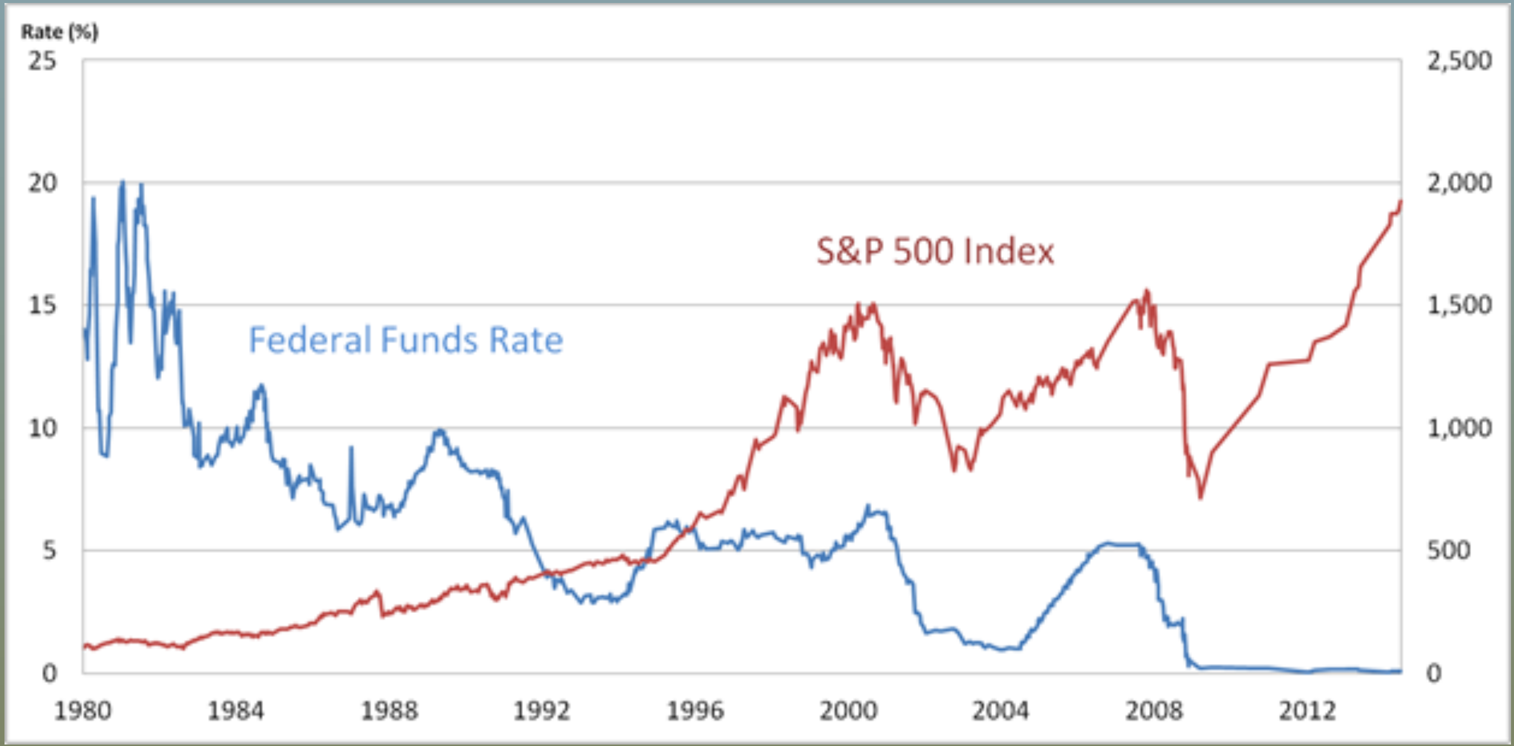
# Federal Reserve: Chairs

# Federal Reserve: Crisis Response

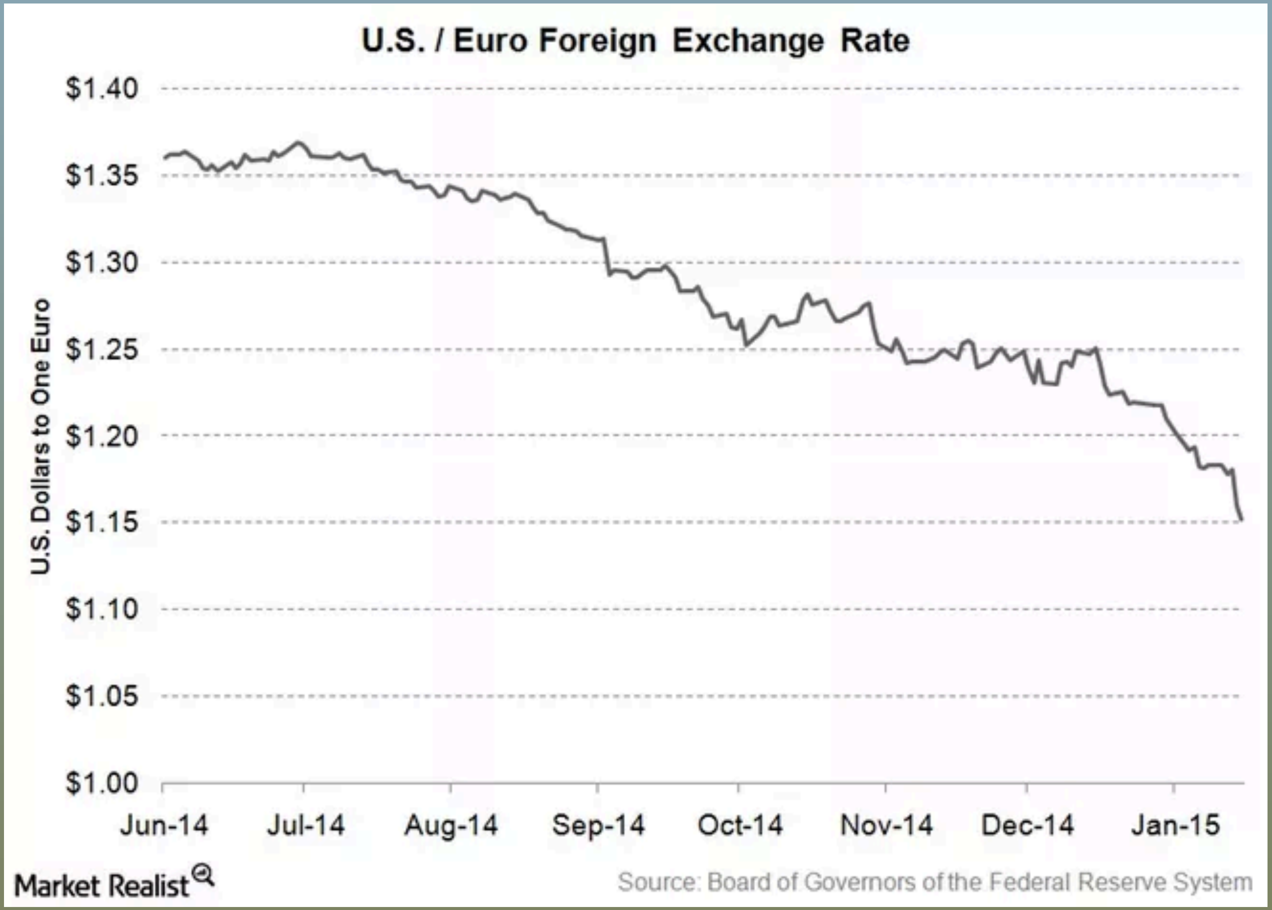


# Federal Reserve: Economic Recovery

# Federal Reserve: Bubble?



# Federal Reserve: Dollar Appreciation



# Challenges for Federal Reserve

Fed might delay rise in Federal Funds Rate if:

- Continued volatility affects financial markets
- Euro falls further, and dollar appreciation hurts U.S. exports and corporate profits

# Challenges for Federal Reserve

- Higher U.S. interest rates affect foreign firms and economies

- IMF very concerned about impact of higher U.S. interest rates on global economy

- In July 2015, IMF advises Fed to hold back raising interest rates until 2016

# Thank you!

Capital Ebbs and Flows:

https://blogs.wellesley.edu/jjoyce/