The Challenges of the Greek Debt Crisis

Joseph P. Joyce
Wellesley College
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%
- 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

Index of Real Per Capita GDP Growth 2003-2014 (2002=100)

Data: Eurostat and Federal Reserve

- US
- Eurozone
- Greece

Greece: Impact of Crisis

Depressions in Greece and the United States

- Blue line: Greece (2007-2014)
- Red line: United States (1929-1936)
Greece: Impact of Crisis

Unemployment rates

- Euro zone
- Germany
- Greece

Data: FactSet
Greece: Impact of Crisis

Under-25 'Youth' Unemployment Rates

- Greece
- Spain
- Euro-Zone

Euro Introduced
Lehman Collapse
Greece: Debt

Greek Debt vs. European Union Average

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/early 2000s:

- 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 $

- Greece
- Ireland
- Portugal

IMF
Europe
Comparison of IMF Arrangements

 IMF: 2010

Mexico | Thailand | Indonesia | S. Korea | Russia | Argentina | Greece | Ireland | Portugal

Millions ($)

% of 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

Countries’ quotas in IMF

Who pays:

Each country’s IMF quota determines how much it contributes, how many votes it has and how much it can borrow.

EU member states 32%
US 17%
Japan 6.1%
China 3.7%
Saudi Arabia 3.2%
Canada 2.9%
Russia 2.7%
India 1.9%
Switzerland 1.6%
Australia 1.5%
Mexico 1.5%
Brazil 1.4%
Korea 1.4%

Others 23.2%

Sources: International Monetary Fund, Graphic News
Graphic by Kinyen Pong
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

![Diagram of Federal Funds Rate](image-url)

- **Fed funds rate (%):**
  - 20.0
  - 15.0
  - 10.0
  - 5.0
  - 0.0

- **Time Period:**
  - Jan-75 to Jan-14

*Source: Federal Reserve Bank of St. Louis*
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/