The Future of Greece

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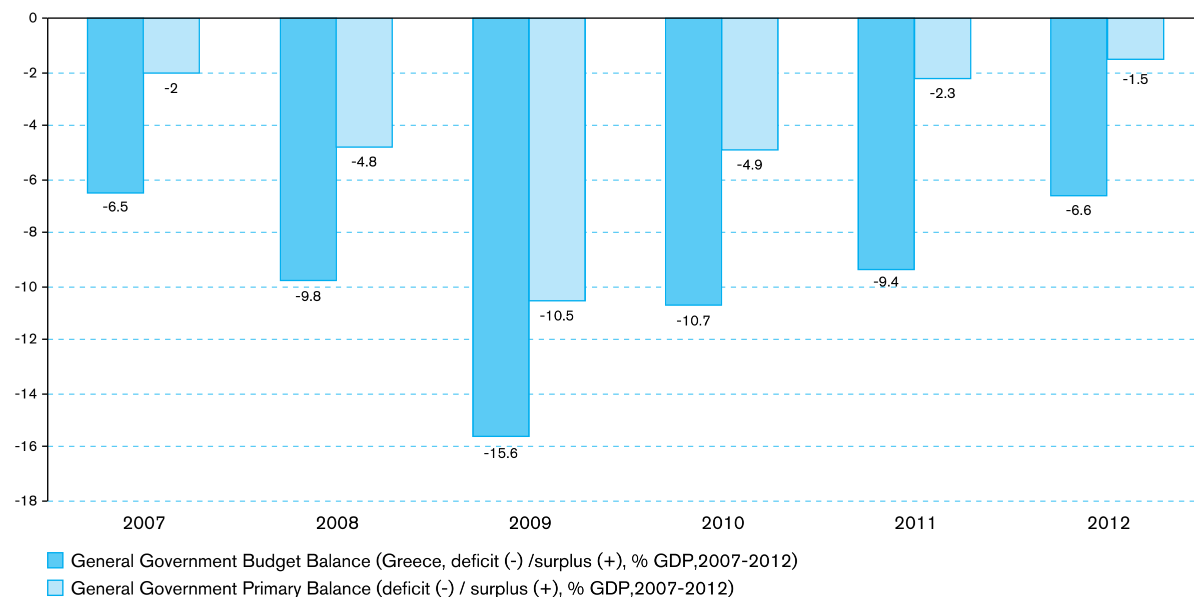
This year will be a crucial one in the ongoing saga of the Greek crisis. In 2013, Greeks will see whether, after six years of economic deterioration and increasing social degradation, they will at last be able to see “the light at the end of the tunnel,” or whether, in view of yet another year of austerity and recession, the relative calm of recent months will give way to a storm.

The Story So Far…

The beginnings of the Greek crisis can be traced back to 2009, when, following the change of government in October, it emerged that the country's projected fiscal deficit was going to be more than double the figure reported by the outgoing government. This revelation shook the country's credibility and focused the attention of financial markets on the desperate state of the Greek economy. Markets were increasingly unwilling to lend to Greece at affordable interest rates, a development that eventually forced it to turn to its European partners for financial assistance. The bailout agreement signed on 2 May 2010 provided for a three-year, €110 billion loan by European Member States and the International Monetary Fund (IMF). The agreement came with strict conditionality in the form of a comprehensive policy programme (memorandum) that would be supervised by the so-called Troika (the IMF, the European Commission and the European Central Bank (ECB)).

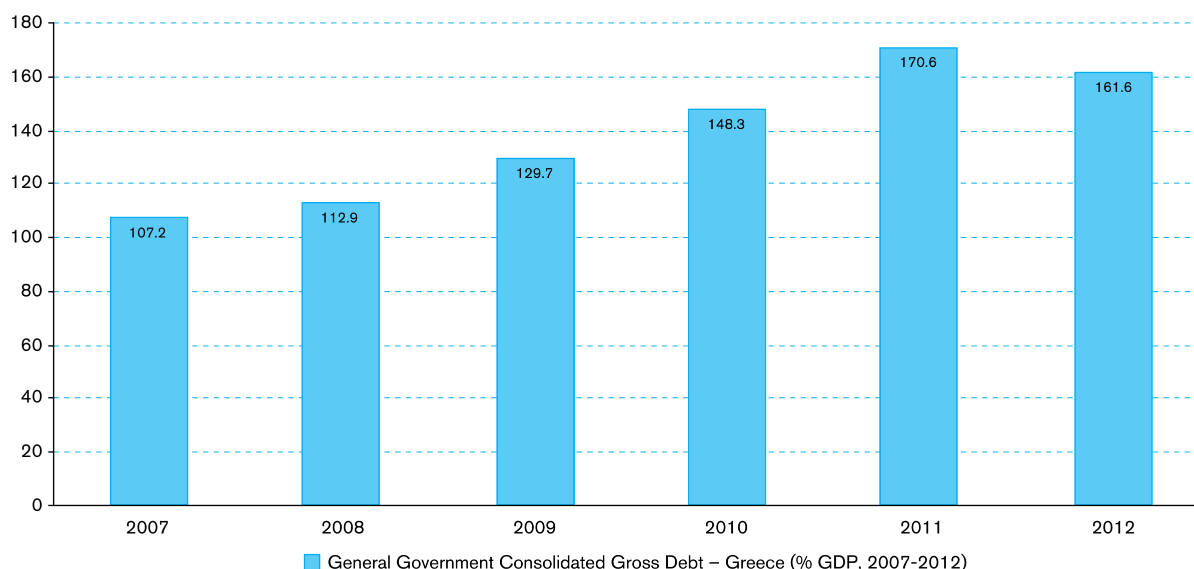
The policy programme called for harsh austerity measures in order to reduce the fiscal deficit and improve the sustainability of the Greek public debt, which at the end of 2009 stood at €300 billion, or 130% of GDP. Horizontal austerity measures, such as cuts in salaries and pensions and tax hikes, were quickly adopted, allowing the government to claim substantial progress on fiscal consolidation from the first year of the programme (Chart 3).
Despite these early positive signs, it soon became evident that the crisis in Greece would not be easily resolved. First, the structural reform programme, intended to help Greece overhaul an expensive and inefficient public sector and improve its international competitiveness, never really took off, largely due to a strong and well-organised opposition from interest groups that stood to lose from its implementation. On the economic front, the adoption of a front-loaded austerity programme soon led to a deep recession. Economic activity ground to a halt as thousands of companies went bankrupt and unemployment rapidly increased. This undermined the success of the adjustment programme as public revenue fell, despite the introduction of a host of new taxes and substantial increases in indirect tax rates, while public expenses rose due to increased payments for unemployment benefits. Deviations in the programme led to more austerity measures, fuelling a downward economic spiral, which increased unemployment to unprecedented levels (Chart 4).
At the same time, the continued decline in GDP undermined the sustainability of Greek public debt, whose ratio to GDP kept increasing despite the substantial reduction in the fiscal deficit (Chart 5).
In this context, it soon became evident that the bailout programme would fail to meet its targets. Indeed, in February 2012, a second €130 billion bailout agreement was signed, which was accompanied by

CHART 3 **General Government Budget Balance - Greece (deficit (-)/surplus (+), % GDP, 2007-2012)**



Note: The data for 2012 are forecasts. Sources: European Commission (2013), *European Economic Forecast: Winter 2013*, Eurostat.

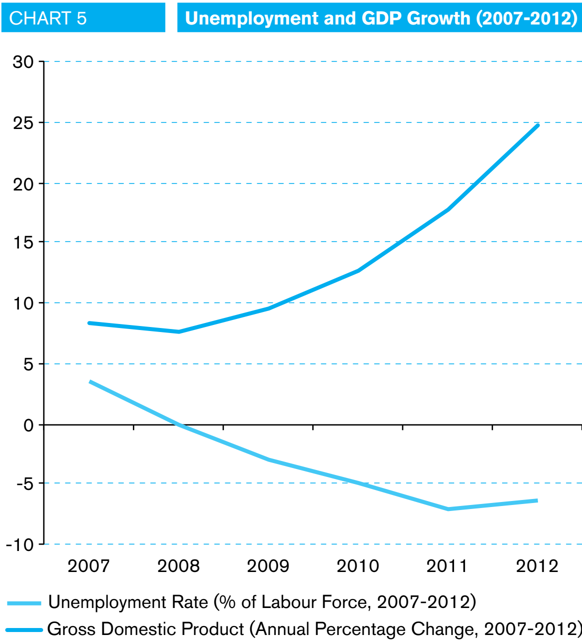
CHART 4 **General Government Consolidated Gross Debt – Greece (% GDP, 2007-2012)**



Note: The data for 2012 are forecasts. Sources: European Commission (2013), *European Economic Forecast: Winter 2013*, Eurostat.

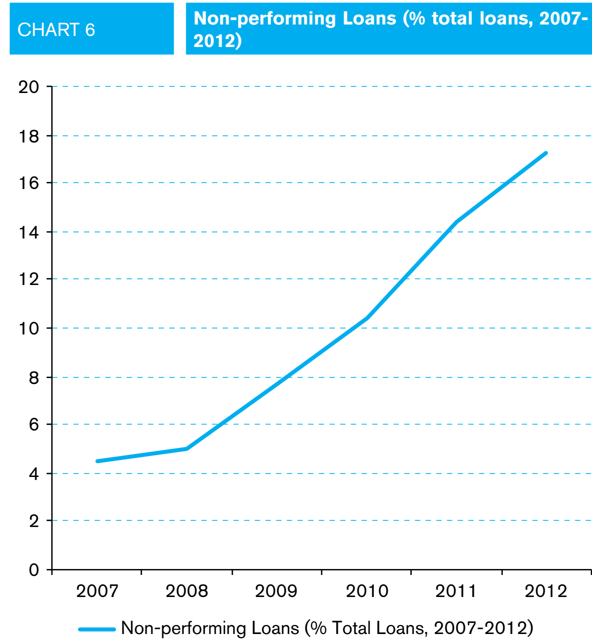
a restructuring of the Greek public debt held by private creditors. The private sector involvement (PSI) deal, which called for a voluntary 53.5% haircut in the nominal value of outstanding bonds, reduced Greek public debt by €106 billion. The new bailout deal and the PSI gave a new lease of life to the Greek rescue programme and substantially improved the maturity and interest rate profile of the Greek debt. However, the deal did not really reduce Greek debt, but rather mostly substituted debt owed to private creditors with debt owed to the public sector. Indeed, part of the second loan is a tranche of approximately €50 billion, which the Greek government borrowed for the recapitalisation of Greek banks, which suffered a substantial loss from the haircut on the government bonds they had in their portfolios. This loss added to the troubles of an already ailing Greek banking system, which, due to the

CHART 5 Unemployment and GDP Growth (2007-2012)



Note: The data for 2012 are forecasts. Source: European Commission (2013), *European Economic Forecast: Winter 2013*, Eurostat.

CHART 6 Non-performing Loans (% total loans, 2007-2012)



Source: IMF, Financial Soundness Indicators (22/2/2013).

uncertainty surrounding the country's future, had suffered a flight of deposits to the tune of €70 billion since 2010. In addition, the continuing deterioration of the economy undermined the health of the banks' loan portfolios, as non-performing loans soared (Chart 6). These problems undermined Greek banks' ability to provide credit to businesses, which further contributed to the liquidity drought in the economy, worsening the downward economic spiral.

Change in the Political Scene

These conditions fuelled frustration and anger among the population. These feelings were openly vented in the elections of 6 May 2012, which fundamentally (and perhaps irrevocably) changed the Greek political map. The once-mighty socialist PASOK, which had come to power in the October 2009 elections, was relegated to third place, falling more than 30 percentage points in the polls. The centre-right New Democracy party did not fare much better, despite having been in the opposition most of this time: although it took first place, it registered its worst electoral result ever. The real winners of the election were parties on the far left and far right, united by their opposition to the bailout agreement and the memorandum. Particularly impressive was the performance of Syriza, a radical left-wing party, which took second place, registering an extraordinary improvement in its share of the vote. Following an impasse in the negotiations to form a coalition government, new elections were called for 17 June. The new elections confirmed the transformation of the Greek political landscape; this time, however, the results offered a way out, as New Democracy, PASOK and the moderate Democratic Left, pressed by the certainty of bankruptcy should the country go to a third round of elections, were able to form a coalition government with a mandate to renegotiate the Greek bailout agreement.

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Throughout the summer and until late October, the new Greek government was engaged in tough negotiations with the Troika over a new €11.5 billion

austerity package (which was eventually raised to €13.5 billion), intended to cover a projected deviation from fiscal adjustment targets in the years 2013 and 2014. The resulting austerity package proved a significant test for the coalition government. Democratic Left, the junior coalition partner, decided to abstain from the vote on the austerity package, due to its disagreement with new interventions in the labour market, while another six MPs from PASOK and one from New Democracy broke party ranks and withheld their support from the new agreement. In the end, the package passed through Parliament with a thin majority of only three votes.

The government hoped that the passage of the new measures would enable a renegotiation of the bailout agreement's terms and the disbursement of a long-awaited tranche of €31.5 billion, delayed since June. Indeed, following the completion of the negotiation with the Troika, the Member States of the euro zone and the IMF were finally able to reach an agreement at the Eurogroup meeting on 26 November. The agreement fulfilled several of the Greek government's objectives: release of €34.4 billion and a schedule for payment of the remainder of the 2012 tranches in the first quarter of 2013, extension of the fiscal consolidation programme for two more years, to 2016, and an array of measures (reduction of interest rates, extension of the maturity of loans, deferral of interest payments, and a plan for a Greek debt buy-back on the secondary market) to reduce the size of the Greek public debt to 124% of GDP by 2020.

Prospects for 2013

The November agreement fell short of providing a final resolution for the Greek crisis (by failing, for example, to address comprehensively the long-term sustainability of the Greek debt); nonetheless, it offered the Greek government a medium-term solution that allowed it to present the agreement as a turning point in the crisis. Moreover, the agreement, in combination with the government's (and Troika's) projections for a gradual return to growth beginning in the last quarter of 2013, has led some people to believe that 2013 will be the year that Greece starts to recover. Could this be true?

There is some evidence that seems to support this optimistic scenario. First, the disbursement of the large tranche of funds agreed in December has allowed the government to start the gradual repayment of approximately €8 billion of arrears to Greek private-sector suppliers – another cause of the liquidity drought in the Greek economy. From December 2012 to March 2013, the government was able to repay some €1.5 billion. Moreover, the disbursement of the December tranche has furnished the necessary funds for the completion of the recapitalisation of the Greek banking system, which, once concluded, is hoped to lead to the restoration of credit provision to the real economy. This expectation is also supported by the observation that, in recent months, following the elections and the November agreement, some €10 billion of deposits have returned to the banking system. Moreover, the November agreement substantially reduced the probability of a "Grexit," which in turn dispelled a significant source of uncertainty, creating more favourable conditions for foreign investment in the country. Indeed, in the first months of 2013, companies such as Hewlett Packard, Unilever and SAP have all announced plans to increase their presence in Greece. Finally, there are positive signs for a very good year on the tourism front.

Are these encouraging signs enough to support a positive outlook for the Greek economy and its prospects of exiting the crisis in 2013? It is hard to say. Too many things are still uncertain, chief among them, the progress of the adjustment programme. As noted, the November agreement, although positive for Greece, hinged on the prior completion of a €13.5 billion austerity package between the Greek government and the Troika; measures totalling €9.5 billion are to be implemented in 2013. This is certain to deepen the recession further, although it is still unknown to what degree. Troika projections put the recession at 4.5% for 2013, but all previous projections have been wrong and subsequently revised downwards. Indeed, the recession is almost certain to be worse than expected given the recent deterioration of the crisis in Cyprus. The haircut on deposits in Cypriot banks will hurt many Greek companies and households, which had deposits in Cyprus, while the deep recession expected this

year in Cyprus will also impact the Greek economy, as the two countries have substantial economic and commercial ties.

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In addition to the intensity of the recession, other factors also suggest a negative outlook for the programme's progress. Progress in structural reforms is still unsatisfactory; in addition to political considerations, this is due to the limited administrative capacity of the state apparatus and its ensuing inability to proceed at the required speed with such comprehensive and complex reforms. The problem is actually getting worse, due to a massive wave of early retirements in the public sector, as public servants try to escape the adverse effects on their retirement plans from changes in the pension system. Moreover, Greece's efforts to regain competitiveness and grow its export base are undermined by the adverse international economic climate; the renewed recession in Europe has slowed down the impressive growth of Greek exports during the first years of the crisis, reducing the potential of exports to contribute to economic recovery.

Finally, one should not forget the political climate in Greece. After five years of austerity and recession, with unemployment rising to 26.4% in December 2012, Greek society is simmering with anger, frustration and desperation. The pressure on the political system to put an end to austerity is immense. The pressure on a politically diverse and fragile governing coalition is even stronger, given the populist rhetoric of parties on both the left and right of the political spectrum. A derailment of the adjustment programme, as a consequence of the aforementioned problems, may necessitate changes, some of which will be very difficult to achieve politically. Even if the governing coalition were somehow to agree to further austerity measures to make up for deviations in the programme, it is highly unlikely that such measures would pass through the Greek Parliament. Greek MPs are under extreme pressure from society and will not support another austerity package. The Greek government must thus overcome all the mitigating factors and somehow make the current programme work. If it does not succeed, the future of Greece will be truly unpredictable. One thing, however, is certain: for better or for worse, 2013 will be a crucial year for Greece.